THE FEDERAL INCOME TAX

A GUIDE TO THE LAW

THE FEDERAL INCOME TAX

A GUIDE TO THE INCOME TAX PROVISIONS OF THE INTERNAL REVENUE CODE, THE INCOME TAX REGULATIONS, AND THE MORE IMPORTANT COURT DECISIONS

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PREFACE

By Randolph E. Paul

Not so very long ago a man of wide experience—a tax expert among many other things, however emphatically he might choose to deny the charge—apparently felt that the time had come to reveal his opinion of tax statutes. The opinion, as reported, is frank, to the point, and not wholly devoid of wounded feelings. It reads:*

> "In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness."

Judge Learned Hand's opinions are well known for leaving little more to be said, and rarely has the Judge been caught in the act of understatement. This time he can hardly be accused of understating the part of the story he chose to tell. But I think he may be guilty of failure to apply his

* Learned Hand, Thomas Walter Swan, 57 Yale L. J. 167, 169 (1947).

talents for salty description to the whole story; at least his vigorous indictment seems too narrow for the case. Perhaps some day the Judge will give us a supplement to his opinion that Bureau Regulations are "thickets of verbiage". Since he is a judge, we can hardly expect him to put in writing his opinion of court opinions in tax cases.

Lacking these further opinions for the time being, it seems fair enough to add a few painful words to what Judge Hand has said. If the "industry and ingenuity" so frequently displayed on Capitol Hill are "fabulous"—and from personal observation I can agree that they are—there are comparable industry and ingenuity in other places. Nor are the products of this later activity particularly different. Much that Judge Hand says about tax statutes can be applied to official Treasury Regulations and rulings. I will remain discreet about court opinions and simply say that their production is at least in quantity. The result is a vast total that makes tax law more formidable than a verbose statute "written with a passion of rationality". One may agree that the trouble starts with this kind of statute, but one may legitimately doubt whether it ends there.

It is no accident that this total is so vast. It would be wholly unreasonable to ask Congress to express in the simple language of a pill advertisement a revenue statute adapted to the complexities of personal life and commerce as we know it today. We may as well reconcile ourselves to the incompatibility of extreme simplicity and the two-fold need for closing down on tax avoidance and granting adequate relief in worthy cases. More than a few sentences are required to take nearly $40 billion, nearly one-fifth of our national income, annually out of the pockets of the millions who earn that national income. And a tax system of such magnitude needs a safety valve. A man who works half time for his Government without being on its payroll had better be allowed to express his distaste for the shape of things that have come and his hope that the shape of things to come will be agreeably different.

These thoughts lead to a point which those who are in-

terested in taxes cannot afford to miss. The material of a tax statute is words. This is the beginning; but words beget words—words of explanation, amplification, disagreement, protest. The process is endless; there can be no last word. The reason is not hard to find. Words are inexact tools; refinement and new adaptations to experience are a constant necessity. Tax law must grow or taxpayers will perish.

In short, the law is language in action. At the moment the action is lively. I see no signs, even on the distant horizon, of any forthcoming lassitude. As Llewellyn has said in another connection: "For too much law, more law will be the cure".*

The Federal Income Tax is important in this context. Its authors have put into readable language a mass of disparate tax material. They start, as they should, with the statute, and their plan of integrating the structure of the book with the Internal Revenue Code prevents them from forsaking the statute at convenient moments in the forgetful manner of some tax writers. But the authors do not end with the statute; they discuss also the Regulations and all court decisions of wide significance. They avoid the thankless task of trying to discuss all court decisions.

The book has balance; space is distributed among subjects with discrimination and due regard for relative values. Explanations are in broad terms with refreshing omission of modifications and exceptions of interest only to the specialist. The book is not a mere paraphrase of the Code and Regulations. It does not pretend to be a treatise, but it cannot be classed as a hornbook. Instead of saying a lot about a little in the manner of much specialized tax writing, the book gives the reader a little—but also needed—fundamental information about a lot of recurring tax problems. It achieves a high level of accuracy. It is completely objective, and contains no special pleading, either for government or taxpayer. It is an explanation of income tax law as it is today, and not, like some books, a statement of what

* The Bramble Bush, p. 122 (1930).

tax law would be tomorrow if the author's suggestions should be adopted.

If my judgment of the book is correct, it should be useful to many types of reader. Beginners in tax law—law students, associates in law offices, judges' law clerks—should find the book indispensable. It gives a view of the forest; it is better, I think, to see the forest at the beginning, even though but dimly, than to see only a few of its individual trees more clearly. Indeed, if the beginner misses this view at the outset, I wonder if he can ever distinctly visualize the same view later along the road. At any rate, the book has the practical value of expediting and clarifying the work of beginners. For this they should be thankful; and so should those who employ them.

I should next mention the sorry plight of the general practitioner. He must draw trusts and wills and divorce agreements; he must handle corporate reorganizations; in daily practice he must constantly tread areas where tax pitfalls beset his every step. The book should help him in this perilous adventure by enabling him to see his hidden tax problems before it is too late. The book may not solve his problems, but seeing may at least be disbelieving apparent solutions that are full of danger.

I could name many more types of persons who should read *The Federal Income Tax.* Recent decisions of the New York courts have hardly relieved accountants completely from the necessity of knowing tax law. Corporate executives will increase their adequacy by familiarity with the fundamentals the book discusses. I have often wished that economists knew more technical tax law, just as they no doubt have often wished that tax lawyers knew more technical economics. I have met employees of the Bureau of Internal Revenue who would not be harmed by contact with *The Federal Income Tax.* But I have saved for the end the most startling suggestion I have to make. It is that the book will be valuable to the tax expert.

Everybody has a hard time with taxes these days—one way or another—but sometimes I think tax experts have the

hardest time of all. They cannot, in perplexity, suggest going to a tax expert; they are it. They are supposed to know and to contribute assurance to clients whose principal passion is certainty in one of the most turbulent areas of present-day law. No alibis are acceptable. Tax experts are the last line of defence; if they fail, their failures are measurable in dollars and cents. This is not to say that their failures will not arouse emotion. "For where your treasure is, there will your heart be also."

I hope that I will not be charged with unfaithfulness to my class when I say that of course we tax experts do not know all that we think we have to pretend that we know. How could we know with any exactness the contents of 1,300 sections of the Internal Revenue Code, 3,000 pages of formal regulations, and 54 volumes of published informal rulings; the implications of more than 20,000 decisions of the Tax Court and Board of Tax Appeals, and of 14,000 tax decisions of the federal district courts, the Circuit Courts of Appeals, the Court of Appeals for the District of Columbia, the Court of Claims and the Supreme Court; the contributions of many textbook writers and hundreds of tax magazine and law review writers; and all the rest of the most prolific technical literature of modern days? In the time left from doing other things, we cannot even read all this literature, much less review the many things we have three-quarters forgotten. Yet the slightest lapse from intimate familiarity may be regarded as proof that we know nothing at all. That at any rate is what many of us fear.

If by some miracle tax experts could know at some one point of time all they feel they must pretend to know, how would we keep that knowledge current? The mills of tax law grind exceeding fast and exceeding fine. Like Alice, we are conditioned to a "slow sort of country", but circumstances have placed us in the other country of the Red Queen where it takes the most breathless and giddy of running to keep in the same place.

All this tends to make the tax expert a near-sighted person. His struggle to master details obscures the general

pattern from his vision, and his knowledge of this general pattern is where his greatest value lies. His real contribution should be a judgment and maturity that must have deep sources. His constant need, therefore, is refreshment of basic outlook. For this, and the restoration of perspective to the bewildered minds of tax experts, I recommend *The Federal Income Tax.*

Washington, D. C.
August, 1948.

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CHAPTER 1

INTRODUCTION

This book deals only with federal income tax law. It has been written to make income tax law easier to understand. It has been written primarily for practising lawyers who do not specialize in tax law, for law students, for accountants working in the tax field and, in general, for all people who in their business or profession need more than a casual knowledge of income tax law.

Income tax law has always been a specialty and undoubtedly will continue to be one. Unlike most specialties, however, it does not confine itself to its own field but insists upon pervading other fields. It cannot any longer be ignored by the general practitioner or by the lawyer specializing in non-tax fields.

Most general practitioners and general corporate or business lawyers have tended to shy away from tax law as they have from such fields as admiralty and patent law. This reaction is understandable in view of the volume, the complexity and the lack of organization of the statutory material; the even greater volume of regulatory material; and the more than 100 volumes of special tax case law. The general lawyer may well believe that tax law can be handled only as a full-time job.

This is partly true and for that reason there will always be tax experts. But two other things are equally true. No lawyer can afford to remain ignorant of tax law as he safely may of many other special fields because tax questions affect so many common transactions. And the general lawyer can, with a reasonable amount of effort and some intelligent guidance, extract from the mass of tax material most of what he needs to know.

This book is designed to make income tax law understandable to those with little or no previous familiarity with the field. It sorts out of the mass of tax material the provisions of general importance and explains what those provisions mean. It will not make the general lawyer a tax expert. It will give the general lawyer the same understanding of tax law that he has of other fields of law in which, though not an expert, he feels thoroughly at ease.

Income tax law is primarily a statutory law, the provisions of which are contained in the Internal Revenue Code. At the present time there are more than 200 sections of the Internal Revenue Code dealing with the income tax and some of these sections contain as many as 20 to 30 subsections. These sections prescribe in minute detail the tax effects of practically all business and personal transactions. While the Code provisions have been amplified by Treasury Department Regulations and interpreted by the courts, the Code provisions themselves are the necessary starting point for anyone who is trying to acquire a general working knowledge of tax law.

In answering any tax problem, the first and major concern is what the Code itself provides. The Regulations and cases have meaning only in connection with a specific provision of the Code. Since the Code provisions are the first things to know and are the framework of the entire tax structure, this book is primarily concerned with and related directly to the Code provisions. In a broad sense, this book is a gloss on the Code.

The book discusses the sections of the Code, one by one, in the order in which they appear in the Code. It explains the meaning of the statutory language itself; it shows the relationship of one section to another; and points out the particular words and phrases of each section that have required interpretation and the general direction which such interpretation has taken. The book covers all the income tax sections of the Code that are of general application. The sections that deal with matters such as tax rates and exemptions are, however, discussed only briefly since they

are relatively familiar to most readers and do not need any particular explanation. The sections that are not of general application, *e.g.*, those dealing with specialized or very technical problems, are not discussed but are referred to in the text of the book in their proper order.

The book discusses those sections of the Regulations which are necessary to a basic understanding of the law, *i.e.*, those Regulations which fill in important gaps in the Code provisions. The most important court decisions are discussed in connection with the particular statutory provisions to which they apply. While a few of those cases are merely interpretative of the Code provisions, most of the cases discussed are those which have stated broad principles as important as the statutory provisions themselves. A knowledge of those cases is essential to an understanding of income tax law. Some of the decisions have resulted in statutory changes in the law; some of the judicially-developed principles have been incorporated in the provisions of the Regulations, while others are not explicitly stated in either the statute or the Regulations. The book does not attempt to discuss the main body of tax case law. It would be impossible in a book of this size to cover with any completeness even a small percentage of the decisions, and the interpretations and distinctions provided by the case law can be better understood after the reader is oriented in the provisions of the Code itself.

The book follows the organization of the Code because the lawyer must know the Code and its organization if he is to have any sound knowledge of tax law. Since the Code itself has had a haphazard growth, with little or no overall planning, this method of treatment frequently entails the separation of related subjects and the discussion of difficult subjects in advance of simpler ones. A good workable knowledge of the Code can, however, only be obtained by a section by section study and the advantages of this treatment seem to far outweigh its disadvantages.

The book is intended to give the reader familiarity with the basic provisions of the Code and the most important de-

cisions of the courts, to point out the problems rather than to give all the answers, and to provide a foundation on which a wider knowledge can be built.

Organization of the Book. As stated above, this book has been written to the Internal Revenue Code and is designed to be read with the Code. To a lesser extent, the pertinent provisions of the Regulations should be read along with the text material. Neither the Code nor the Regulations have been reprinted as part of the book itself as they are very long and as they are already available in inexpensive reprints.

Most of the sections of the Code dealing with income taxes are contained in Chapter 1 of the Code. That chapter is now divided into three subchapters, Subchapter A, Subchapter B and Subchapter C. Subchapter C, which is headed "Supplemental Provisions", is in turn divided into 21 supplements. In the majority of cases the divisions of subchapters and supplements are without significance since the sections within those divisions are not confined to a particular subject and do not always contain all the provisions on a particular subject. Some of the later supplements of Subchapter C are exceptions, however, in particular, Supplement E dealing with estates and trusts, Supplement F dealing with partnerships, Supplement H dealing with nonresident aliens, Supplement I dealing with foreign corporations, Supplements L, M, N, and O containing the procedural provisions, and Supplement P dealing with foreign personal holding companies. In those cases (and in some others which are not of general interest) the supplements are devoted to a single subject and fairly well exhaust the special provisions covering that subject. In the case of those supplements, this book has considered each supplement as a unit, and has discussed it more or less as if it were a single section. In all other cases, however, each section of Chapter 1 has been taken up individually and the larger divisions to which the section belongs have been disregarded.

The sections contained in Chapter 1 of the Code are numbered, beginning with Sec. 1 and ending with Sec. 421. Most of the sections then contain subsections, paragraphs and subparagraphs as, for example, Sec. 23, Sec. 23(a), Sec. 23(a)(1) and Sec. 23(a)(1)(A). With very few exceptions, this book takes up the individual sections of Chapter 1 in the order in which they appear in the Code. The book also discusses, in Chapter 11, Secs. 500–511 dealing with personal holding companies, which are contained in Chapter 2 of the Code. The book does not discuss in detail any of the other provisions of later chapters of the Code, though references are given to later relevant sections. It should be noted that certain sections of Chapter 1 of the Code are blank. Some of these sections are blank because the provisions that were originally included in the sections have been repealed; other sections have been left blank in order to provide space for further provisions that may later be added to the Code.

The income tax Regulations are contained in Regulations 111. The numbering of the Regulation sections follows that of the Code except that each section number of the Regulations is preceded by the number 29; this is because Regulations 111 constitute Part 29 of Title 26 of the Code of Federal Regulations. For example, the Regulations under Sec. 22(a) of the Code are numbered Sec. 29.22(a)-1 to Sec. 29.22(a)-22.

Since not all the sections and subsections of the Code are discussed, the following procedure has been adopted for the guidance of the reader. Every main section that is not discussed is referred to in the text of the book in its proper statutory order, and the section number and section title given, so that the reader may be aware that such a section exists. When, however, a main section is discussed but certain of the subsections within the main section are not discussed, no reference is ordinarily made to the omission of the subsection. An exception to this latter rule has been made in the discussion of Sec. 22 (Gross Income), Sec. 23 (Deductions from Gross Income), Sec. 112 (Recognition of Gain or Loss) and Sec. 113 (Adjusted Basis for Determin-

ing Gain or Loss); the subsections contained in those sections are so numerous and so important that the subsections are discussed separately, and when a subsection is omitted from discussion specific reference to the omission is made.

When cases are discussed or mentioned in the text they are referred to by their popular rather than their exact names. For example, the *Kirby* case is referred to by that name rather than as *United States v. Kirby Lumber Co.* The exact citation is given in the footnotes. Consonant with this practice, certain of the courts are also referred to in popular terms; for example, the Circuit Court of Appeals for the Second Circuit is sometimes referred to as the Second Circuit and the Board of Tax Appeals is referred to as the Board. The Commissioner of Internal Revenue and the Bureau of Internal Revenue are ordinarily called merely the Commissioner or the Bureau, the terms being used interchangeably.

The discussion of the Code provisions is limited, in most cases, to a discussion of the terms of the provisions as they exist at the present time, *i.e.*, the provisions as amended by the Revenue Act of 1948. In most cases no reference is made to the effective date of the present provisions of a particular section. The effective dates of the sections and the provisions of the sections prior to their amendment are contained in notes appended to the Code sections in most editions of the Code. These notes should be referred to by the reader since the effective date of a particular provision is often of very great importance.

The Revenue Act of 1948 made several important changes in the law. It lowered the tax rates on individuals, estates and trusts. It increased the personal exemptions and the credit for dependents, and increased the minimum requirements for the filing of returns. It also increased the standard deduction and made several other minor changes. In the text discussion of those sections of the Code which were amended by the 1948 Act the discussion refers only to the provisions in their present, amended form.

The most important change made by the 1948 Act is the provision permitting "income-splitting" by a husband and wife. Prior to the enactment of the 1948 Act, a husband and wife could each file a separate return and pay tax on his or her own income; or they could file a joint return, including the income and deductions of both, and pay a tax computed on the total taxable income. However, in the twelve community property states the income of a married couple was (in most circumstances) treated for tax purposes as belonging half to the husband and half to the wife and each was taxed on one-half the income. Because of the progressive rate structure, the result was that the tax liability of a married couple in a community property state was usually considerably lower than the tax liability of a married couple with the same total income in a non-community property state. This tax disparity between married couples in different states was equalized by the provisions of the 1948 Act which permit "income-splitting" by all married couples.

Under the new law, if a husband and wife file a joint return, the tax, instead of being computed on the total taxable income, is computed on one-half the income and the tax so computed is then doubled. The effect is to permit all married couples to compute their tax as if the husband and wife had each received one-half the income and been allowed one-half the deductions. The amendments made by the 1948 Act are effective, in general, for the calendar year 1948 and for that part of fiscal years that falls within 1948.

Tax Materials and Bibliography. The basic working tools of the tax practitioner are the Internal Revenue Code and the Regulations. Commerce Clearing House, Inc., publishes a paper-bound edition of the Code, as does The Alexander Publishing Company. These are both periodically revised. There are also more expensive loose-leaf editions published by Commerce Clearing House, Inc., and Prentice-Hall, Inc., which are kept up to date by frequent reports. The Code is, of course, also included as Title 26 of the United States Code

Annotated, published by West Publishing Co. and Edward Thompson Company.

The income tax Regulations, Regulations 111, are issued by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury. The Regulations amplify, supplement and interpret the statutory provisions and give examples of the application of specific provisions to particular sets of facts. Commerce Clearing House and Prentice-Hall publish paper-bound editions of the Regulations which are periodically revised. Copies of the Regulations can also be obtained from the Government Printing Office.

The binding effect of the Regulations is a question of great difficulty. In some instances, the Regulations merely set out the Treasury's interpretation of the proper construction of a statutory provision. In other instances, when a statute is enacted in broad terms, the Congress specifically delegates to the Treasury power to promulgate Regulations covering the details of the provisions. The latter type of Regulation will in many cases have the force and effect of law. But, at a minimum, the Regulations of either type will be followed by the Bureau personnel and be given great weight by the courts.

The Bureau of Internal Revenue issues, in addition to the formal Regulations, a large number of rulings on income tax matters. These are designated as G.C.M.s (General Counsel's Memoranda) and I.T.s (Income Tax Unit). The rulings are numbered serially and are published in the Internal Revenue Bulletin, issued semi-monthly by the Bureau of Internal Revenue. The bulletins for each six-month period are printed as a Cumulative Bulletin. The rulings are cited by reference both to the ruling number and the volume and page of the Cumulative Bulletin, for example, I.T. 3795, 1946-1 C.B. 15. These rulings do not carry as much authority as the Regulations but they are important guides to the position that will be taken by the Bureau with respect to transactions involving facts similar to those covered by the rulings.

Tax decisions come down from several courts. Most tax cases originate in the Tax Court of the United States. Prior to October 1942 the Tax Court was called the Board of Tax Appeals and the decisions of the Board are published in 47 volumes cited as B.T.A. Since October 1942 the court has been called the Tax Court and a new series of reports contains the Tax Court decisions; these volumes are cited as T.C. Many of the decisions of both the Board of Tax Appeals and the Tax Court are issued in memorandum form only and are not included in the official B.T.A. or T.C. reports. These memorandum decisions are, however, published by both Commerce Clearing House and Prentice-Hall.

Some tax cases originate in the federal district courts and in the Court of Claims. Appeals from the decisions of the Tax Court (and formerly of the Board of Tax Appeals) and of the federal district courts are taken to the several circuit courts of appeal. The tax decisions of the circuit courts and the Court of Claims are reviewable by certiorari granted by the Supreme Court. The tax decisions of the district and circuit courts, the Court of Claims, and the Supreme Court, in addition to being reported in the regular reports, are also reprinted by Commerce Clearing House as United States Tax Cases (USTC) and by Prentice-Hall as American Federal Tax Reports (AFTR).

Invaluable tax material is contained in the tax services: the Standard Federal Tax Reporter, published by Commerce Clearing House; the Federal Tax Service, published by Prentice-Hall; and the Federal Tax Coordinator, published by Research Institute of America. The services are published in large loose-leaf volumes which are kept up to date by weekly reports and are completely revised every year.

There are also several standard treatises that deal with income tax law. The most exhaustive is Mertens, Law of Federal Income Taxation, in twelve volumes, which is kept up to date by monthly supplements and annual pocket parts. The others are Rabkin and Johnson, Federal Income, Gift and Estate Taxation, a two-volume service which is

kept up to date by monthly reports, and Montgomery's Federal Taxes—Corporations and Partnerships, in two volumes which are revised annually.

Two other important publications are the two series of pamphlets published jointly by the American Bar Association and the Practising Law Institute. The individual pamphlets in each series are kept up to date by periodic supplements. The first series, called "Fundamentals of Federal Taxation", covers different aspects of the entire field of income, estate and gift taxes; the second series, called "Current Problems in Federal Taxation", deals with tax problems at a more advanced level.

The various law reviews from time to time contain important articles and notes on current tax problems. Two periodicals, the Tax Law Review, published quarterly by the New York University School of Law, and Taxes, The Tax Magazine, published monthly by Commerce Clearing House, are devoted entirely to tax articles.

CHAPTER 2

SECTION 1 TO SECTION 22

* Regulations 111.

Sec. 1 (Application of Chapter), Sec. 2 (Cross References), Sec. 3 (Classification of Provisions) and Sec. 4 (Special Classes of Taxpayers) are introductory sections and need no discussion.

Sec. 11 (Normal Tax on Individuals) and Sec. 12 (Surtax on Individuals) contain the rates of tax on individuals. The rate schedules themselves were last revised by the Revenue Act of 1944 but taxes have actually been reduced twice since that Act. The 1945 Act provided that the combined tentative normal tax and surtax as computed under the 1944 rates should be reduced by 5%. This provision was replaced by the new provisions of the Revenue Act of 1948. Those provisions, contained in Sec. 12(c) of the Code, are as follows:

If the combined tentative normal tax and surtax as computed under the 1944 rates is:

1) $400 or less, the reduction is 17% of the tax so computed.
2) More than $400 but not more than $100,000, the reduction is $68 plus 12% of the excess over $400.
3) More than $100,000, the reduction is $12,020 plus 9.75% of the excess over $100,000.

In addition, Sec. 12(c)(2) provides that the combined normal tax and surtax can not exceed 77% of the net income. The previous limitation had been 85½%.

The most significant change made by the 1948 Act was the addition of a new section, Sec. 12(d), which provides for the splitting of income between husband and wife. From an early date the courts have consistently refused to allow a

taxpayer to reduce his tax by assigning a part of his income to another. This subject is discussed more fully at pages 17 and 32 below. On the other hand, in 1930, the Supreme Court held, in *Poe v. Seaborn,** that in a community property state half of the "community income" (which includes the earnings of both parties plus the income from community property) should be taxed to the wife and half only to the husband. Since that decision married couples in community property states, of which there were originally eight, have enjoyed a very substantial tax advantage over couples in the common law states, an advantage which became more and more marked as tax rates increased. A number of states adopted legislation specifically designed to procure that advantage.

The present Sec. 12(d) is designed to remove that inequality. That section provides that where a husband and wife file a joint return the tax shall be twice the tax that would be determined if the net income and the applicable credits were reduced by half. As an example of the operation of this provision, assume that a taxpayer has $10,000 gross income and deductions of $1,500, that his wife has no income, that they have one child. If the couple files a joint return the combined net income is $8,500, the applicable credits are $1,800 ($600 each for the taxpayer and his wife and $600 for their dependent child, see page 101 below). The tax is first computed on $3,350 (one half of $8,500 less one half of $1,800); this would be $593. This tax is then doubled to produce the tax due on the joint return of $1,186. If the husband filed a separate return taking full credits for himself, his wife and his child, the tax would be $1,361.

Sec. 13 (Tax on Corporations in General), Sec. 14 (Tax on Special Classes of Corporations) and Sec. 15 (Surtax on

* 282 U.S. 101 (1930).

Corporations) contain the rates of tax on corporations. These rates were not affected by the 1948 Revenue Act. For corporations with net income of over $50,000, the normal tax rate (Sec. 13) is 24% and the surtax rate (Sec. 15) is 14%, making a total of 38%. For corporations with net income of less than $50,000, Secs. 13, 14 and 15 provide lower rates:* the combined normal and surtax rate ranges from 21% up to 38% depending on the size of the net income. Most editions of the Code contain tables showing these rates in schedule form. When the "corporate tax rate" is referred to in this book, it is the 38% rate that is meant.

Sec. 21 (Net Income) defines net income as gross income computed under Sec. 22 less the deductions allowed by Sec. 23.

Sec. 22 (Gross Income)

Sec. 22 which is discussed in the balance of this chapter, Sec. 23 (Deductions From Gross Income) and Sec. 24 (Items Not Deductible) discussed in the following chapter, set out the basic rules for determining net income, that is, gross income less deductions. These sections are very long, containing many subsections, and they are easier to follow if their pattern is first understood. Sec. 22 deals only with gross income. Sec. 22(a) includes in gross income all income items that are not specifically excluded by Sec. 22(b) or certain other later sections; Sec. 22(b) then lists certain items which are not subject to income tax and which are not included in gross income. Sec. 23 lists the items that are deducted from gross income in determining net income; and Sec. 24 lists those items that cannot be deducted.

* Certain foreign corporations do not receive the full benefit of these lower rates (Sec. 14(c)). These corporations are discussed in Chapter 9.

Sec. 22(a) (General Definition) states in very broad terms the items that are included in gross income. The section, in its first sentence, includes in gross income "gains, profits, and income" derived from a long list of sources mentioned, and then ends by including in gross income "gains or profits and income derived from any source whatever". The section, in effect, includes in gross income all items that are constitutionally income and that are not excluded by the provisions of some other section. The arrangement of Sec. 22(a) is unlike that of other sections such as Sec. 22(b) and Sec. 23 in that Sec. 22(a) states only a general rule and is not followed by subsections setting out the special rules applicable to particular types of income. The special rules relating to gross income are contained in the Regulations under this section (Secs. 29.22(a)-1 to 29.22(a)-22). In other sections such as Sec. 22(b) and Sec. 23 the special rules are stated in subsections of the Code and amplified in the Regulations.

General Income Concepts. Before the special rules covering particular types of income are discussed a few general concepts need to be mentioned; these have been developed to a large extent through case law and some of them are not directly stated in either the Code or the Regulations. These concepts are discussed briefly at this point because they underlie and affect a great many of the Code provisions dealing with the taxation of particular types of income.

Income v. Capital. The tax is levied on income so that the primary question is whether or not an item is income. The broad distinction is, of course, between income and capital. The theoretical question of what is income does not need to be discussed here, since for practical purposes the question has to be answered in accordance with the statutory and preexisting case law, and many of the distinguishing lines have already been drawn. In this country, of course, capital gains are included within the term "in-

come" whereas in England with certain exceptions, they are not. Under our law a distinction is made in the rates of tax on capital gains * and ordinary income but both types of income are subject to tax. At the present time capital gains are taxed at a maximum rate of 25% ** whereas ordinary income is taxed at a rate which may be as high as 38% for corporations and as high as 82% † for individuals. It is easy to see why taxpayers try to cast as many transactions as possible in such a form that the gain will be a capital gain rather than ordinary income. In using the terms, the distinction should be made not between "capital gains" and "income" but between "capital gains" and "ordinary income" since both items are included in the term "income".

Necessity for realization. A doctrine of general importance is that gains must be "realized" before they become taxable as income. When a gain is "realized" there is ordinarily some segregation of the gain. If, for example, a taxpayer buys a share of stock for $50 and continues to hold it when it has increased in value to $60, there is no income and no tax since the gain has not yet been realized; there is merely an appreciation in value. If he sells the stock the gain of $10 is realized and is taxed at that time. Changing the example, the corporation might capitalize its surplus and pay a stock dividend to the taxpayer

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* The special tax rate applies in fact only to "long-term" capital gains, *i.e.*, where the property has been held for more than six months. "Short-term" capital gains, *i.e.*, where the property has been held for not more than six months, are taxed at the same rates as ordinary income. In many places in the text, as in ordinary speech, where reference is made to the capital gain rate the reference is to the rate of tax on long-term capital gains.

** The 25% rate on capital gains is a limiting rate, that is, the tax on capital gains cannot exceed 25%; the rate is less than 25% for taxpayers whose tax rate in the highest bracket is less than 50% (see Chapter 7).

† Combined normal tax and surtax of 91% reduced by 9.75% of 91%, or by about 9%.

which dividend would to some extent represent the appreciation in value. The question then arises whether the stock dividend is a sufficient segregation of the gain to constitute a realization of it. This is the basic issue in the question of the taxability of stock dividends, discussed later in Chapter 7. The most complicated problems in connection with realization are those that have arisen when property which has increased or decreased in value is exchanged for other property rather than being sold. To a large extent these questions have now been settled by the provisions of Sec. 112 of the Code (discussed in Chapter 5).

Constructive receipt. It is hardly necessary to state that income does not need to be actually received before it is includible in gross income. Most people are familiar with the fact that taxpayers may report income on either a cash basis or an accrual basis; and that income can be accrued prior to its receipt.* But there is a further doctrine—that of constructive receipt—which may not be quite so familiar and which is applicable only to cash basis taxpayers. Under this doctrine a cash basis taxpayer has to include in gross income amounts which he has an unqualified right to receive although there has been no actual receipt. Simple examples are interest that has been credited on a savings bank account and salary that has been unconditionally credited to a drawing account although it has not been actually withdrawn. In most situations where this doctrine is applied the purpose is to prevent a taxpayer from obtaining a tax benefit by postponing the receipt of income, entirely of his own volition, to some later year when his surtax rate may be lower.

Assignment of income v. transfer of property. Taxpayers can also be taxed on income which they never receive themselves but which is received by other persons. For ex-

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* The accrual and cash basis methods or reporting income are discussed in Chapter 4.

ample, if X directs his employer to pay part of his salary to X's creditor (or to X's wife or any third person) rather than to X directly, the amount paid is clearly income to X since he has had the full benefit of the payment; this is really only another example of constructive receipt. X cannot avoid the tax on the full amount of the income by assigning any part to another person. The same rule applies to the assignment of any type of income, that derived from property as well as that earned by personal services. The assignment of income itself has no tax effect and the income remains taxable to the person who performed the services or who owned the property that produced the income. On the other hand, if a taxpayer transfers income-producing property to another person, the income from the property will be taxed to the other person; this is true, however, only if the transfer is complete and bona fide and the taxpayer retains no control over the property or the income. These questions of assigning income and transferring income-producing property are discussed at greater length later in this chapter.

Transfers in trust. The same question of who is taxable on income arises in many cases where a taxpayer transfers property in trust, the income to be paid to a third person. The rules are comparable to those relating to assignments of income and transfers of property; and the grantor of the trust remains taxable on the income if he retains rights to benefit from or to control the disposition of the property or the income. Many of the questions in connection with trusts are covered by Secs. 166 and 167 (discussed in Chapter 8) which, in sum, tax the trust income to the grantor if the trust is revocable, or if the trust income can be used for the benefit of the grantor. In those situations, the grantor remains taxable on the income because he has not completely parted with his right to receive it or to benefit from it. There is another important group of trusts, known as *Clifford* trusts, where the grantor remains taxable on the

income even though the trusts do not come within the provisions of Secs. 166 and 167. The income of these trusts is taxed to the grantor under the broad provisions of Sec. 22(a) on the theory that he has retained so much control over the disposition of the income or the management of the property that he is in substance still the owner. These *Clifford* trusts are also discussed in Chapter 8 in connection with the trusts included within the provisions of Secs. 166 and 167.

Particular Types of Income. The rules with respect to particular types of income included in gross income under Sec. 22(a) are not stated in the Code provisions themselves but are set out in Secs. 29.22(a)-1 to 29.22(a)-22 of the Regulations. The most important provisions of those sections of the Regulations are now discussed in their numerical order. That order is followed because this book is planned as a guide to the provisions of the Code and the Regulations; and the advantages of following the numerical order seem to outweigh the disadvantage of having to consider, at times, some of the more difficult provisions in advance of slightly simpler provisions.*

Sec. 29.22(a)-1—General rules, transfers of property to stockholders or employees at less than fair market value.** The first paragraph of this section is merely a statement of general rules. The second and third paragraphs, however, cover the very important cases of purchases of property by stockholders and employees at less than the fair market value of the property.

The subject of corporate distributions to stockholders is

* In a very few cases, certain Code provisions are discussed out of their numerical order. This exception has been made only when it has seemed absolutely essential to an understanding of the provision.

** Secs. 29.22(a)-1 to 29.22(a)-22 discussed in pages 19 to 32 are sections of Regulations 111.

taken up more fully in Chapter 7. Disregarding particular types of distributions to which special rules are applicable (such as non-taxable stock dividends, stock rights and liquidating dividends), the general rule is that any distribution of property by a corporation to a stockholder is taxable income, *i.e.*, a dividend to the stockholder, to the extent that the corporation has earnings and profits. The precise meaning of the phrase "earnings and profits" is discussed later in Chapter 7. For the moment "earnings and profits" can be thought of as meaning the earned surplus of a corporation, with the reservation kept in mind that there are sometimes many differences between the two.*

The second paragraph of this section of the Regulations merely states a special application of the general rule covering corporate distributions to stockholders. It states that, if a corporation transfers property to a *stockholder* for an amount less than its fair market value, the difference between the amount paid by the stockholder and the fair market value is dividend income to the stockholder to the extent that the difference is "in the nature of a distribution of earnings and profits taxable as a dividend". A distribution by a corporation of $1,000 worth of property to a stockholder is in the usual case taxable income to the stockholder in the amount of $1,000. If, instead of distributing $1,000 of property, the corporation sells the stockholder $2,000 worth of property for $1,000, the Regulations make it plain that the difference between the sale price and

* When earnings and profits that have been accumulated on or after March 1, 1913 (the effective date of the Revenue Act of 1913—the first income tax act subsequent to the 16th Amendment) are distributed, the distribution is a "dividend" within the terms of the Code. Distributions of earnings and profits accumulated prior to March 1, 1913 are not taxable as dividends. Unless otherwise stated, references in the text to "earnings and profits" are to post–1913 (*i.e.*, post February 28, 1913) earnings and profits.

the market value is a taxable distribution, assuming, of course, that there are sufficient earnings and profits.

There is no particular complication in those cases where there is a present sale of property to the stockholders. In many cases, however, the corporation extends to its stockholders an option, good for some certain period, to purchase corporate assets at a fixed price. Thus, if corporation A (with sufficient earnings and profits) owns stock of corporation B worth $50 a share, it may give its stockholders a six-months' option to buy the B stock pro rata at $40 per share; if the B stock is still worth $50 a share when the option is exercised the spread of $10 between the option price and the market price will be a taxable dividend to the stockholder.*

Under the present interpretation of the law, the stockholder's income cannot exceed the spread which existed at the time the option was given; nor can it exceed the spread which exists when the option is exercised. If, for example, an option is given to buy stock at the then market price, there can never be any income to the stockholder regardless of the market price at the time the option is exercised. If, on the other hand, an option is given to buy at $40 at a time when the market price is $50 and the option is exercised at a time when the market price is $45, the income to the stockholder is limited to the $5 spread existing at the time of exercise. (There is a very clear discussion of this question in the opinion of the Second Circuit Court in the *Choate* case.**)

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* The examples given in the text are usually far simpler than any facts that ever occur in real life; and the fact that any particular example is used does not necessarily mean that the facts assumed are the most common ones. In general, however, the present discussion is applicable irrespective of the *type* of property involved except for stock or rights to buy stock of the corporation making the distribution which are governed by the special rules discussed in Chapter 7.

** Choate v. Commissioner, 129 F.2d 684 (C.C.A. 2d 1942).

It is also important to remember, in connection with the use of options, that the stockholder receives income through the exercise or sale of the option; the mere receipt of an option does not constitute income.

The third paragraph of Sec. 29.22(a)-1 is comparable to the second paragraph but refers to *employees* rather than stockholders. It provides that if an employer transfers property to an employee for less than its fair market value the difference is taxable income to the employee. Here, too, problems arise most frequently in connection with options (usually those to buy stock in the employer corporation). If, for example, a corporation gives an employee an option to buy its stock at $50 a share at a time when the stock is selling at $60 and the option is exercised when the stock is selling at $60, the $10 the employee saves is taxable income to him. This paragraph is unlike the preceding paragraph of this section, dealing with stockholders, in one very important respect. It is not necessary under the present Regulations with respect to employees that the difference between the price paid and the fair market value should be in "the nature of compensation for services", whereas it is necessary where sales to stockholders are concerned that the difference should be in the nature of a taxable dividend. Under the present Regulations there is a conclusive presumption that any spread in favor of an employee represents compensation for services and so is taxable income; this particular presumption is new in the Regulations and may not be upheld by the courts.*

The Regulation was followed by a Bureau ruling** which lays down several further rules with respect to employee stock options. As in the case of options received

* There is, of course, always a strong factual presumption that amounts paid by an employer to an employee are paid as compensation for past, present or expected services.

** I.T. 3795, 1946-1C.B. 15.

by stockholders, no income results from the mere receipt of the option; there is income only at the time the option is exercised or sold. However, under the Bureau ruling, if the option is exercised the amount of income is the spread between the option price and the fair market value of the stock at the time of the *exercise,* irrespective of the existence of or the amount of any spread at the time the option was received. This rule is quite unlike the rule applied by the courts to options received by stockholders. For example, suppose X receives an option to purchase B stock for $60 at a time when the fair market value is $70; the stock increases in value to $80 at which time X exercises the option. If X is an employee, he has, under the present ruling, received income of $20. If X is a stockholder he has received income of $10—the spread at the time he received the option; the later appreciation in value would not be income to a stockholder. The rules which have been laid down in I.T. 3795 with regard to employees flow out of the Supreme Court's decision in the *Smith* case;* as stated before, it is not yet known whether they will be upheld by the courts in all employee stock option cases.

Sec. 29.22(a)-2—Compensation for personal services. This section of the Regulations lists many items that are to be treated as compensation for personal services. Also, the following section of the Regulations, dealing with compensation paid other than in cash, points out several further items that are treated as compensation for services. An important distinction that must often be made is that between compensation for services, which is taxable, and a gift or bequest, which is not taxable. When an employer pays additional amounts to an employee, over and above his salary, the question sometimes arises whether the amounts are compensation or a gift. Although it is possible

* Commissioner v. Smith, 324 U.S. 177 (1945).

for the payment to be treated as a gift if the circumstances clearly show that a gift was intended, there is ordinarily a strong presumption, because of the employer-employee relationship, that the additional amounts are compensation. If the employer is a corporation this presumption is reinforced by the general rule that corporate directors are not normally authorized to give away corporate assets. The problem of distinguishing between compensation and gifts (or, more exactly, legacies) also arises in connection with amounts payable to an executor under a will; there the question is whether the executor is entitled to receive the payment irrespective of the performance of services (nontaxable legacy) or whether the receipt is conditioned upon the performance of services (taxable income).

There was at one time a great deal of argument and litigation about the constitutional right of the federal government to tax the salaries of state and municipal employees; that argument has been settled in favor of the federal government and the Regulations now specifically include those salaries in taxable income.

Sec. 29.22(a)-3—Compensation paid other than in cash and Sec. 29.22(a)-4—Compensation paid in notes. The general rule of these two sections is that the amount to be included in income is the fair market value of any property received in payment of the services. If, for example, an employee receives a promissory note or other evidence of indebtedness as compensation, and the note has a present fair market value, that amount must be included in income; if the note could be discounted at 10%, the discounted value is the fair market value of the note. A common example of compensation paid in kind is the situation where an employer provides board and room, without charge, to an employee. Except when the board and room are provided solely for the convenience of the *employer,* their value is taxable income to the employee. If the board and room are provided

solely for the convenience of the employer, as, for example, in the case where hotel employees are required to live in quarters furnished for them, the value of the board and room is not included in income. Another common type of compensation paid in other than cash is the payment by an employer of premiums on a life insurance policy for the benefit of an employee. Such premiums are clearly income to the employee since he receives a direct and immediate benefit from the insurance coverage; the employee must include the premiums in income and the employer may deduct them as additional compensation. There is, however, a special exception in the case of group life insurance; here, although the employer can deduct the premiums paid, the employees need not include the amounts in income.

Sec. 29.22(a)-5, Sec. 29.22(a)-6 and Sec. 29.22(a)-7 are not discussed. Sec. 29.22(a)-5 merely states what is a general accounting rule, that the gross income of a manufacturing, merchandising or mining business is the gross receipts less the cost of goods sold plus any other income. Sec. 29.22(a)-6 refers to state contracts and Sec. 29.22(a)-7 deals with the gross income of farmers.

Sec. 29.22(a)-8—Sale of stock and rights. This section sets out the rule to be applied when a taxpayer who has purchased stock in a corporation at different times and prices sells part of his shares and cannot identify which shares he has sold. The rule—known as the "first-in, first-out" rule—is that he is deemed to have sold the first shares he purchased. If he *can* identify the shares sold there is no need to apply this presumption, and the taxpayer computes his gain or loss by reference to the actual cost (or basis *)

* The rules for determining the "basis" of property are contained in Sec. 113 which is discussed in Chapter 6. Since, however, the term "basis" has to be used in the text prior to the discussion in that chapter, a very elementary and not entirely exact definition of the term is given here.

of the shares sold. This section also sets out certain rules to be applied when a stockholder has received rights to subscribe to additional stock, which rights were not taxable income when received, and either exercises or sells the rights. These rules involve rather complicated questions of basis and of the taxability of stock rights and are not discussed here. The taxability of stock dividends and rights is discussed in Chapter 7 and the method of determining the basis of such property is discussed in Chapter 6.

Secs. 29.22(a)-9, 29.22(a)-10, 29.22(a)-11 and 29.22(a)-12 are not discussed. Those sections set out certain rules applicable, respectively, to the sale of patents and copyrights, the sale of good will, the sale of real property in lots, and the taxability of certain annuities and insurance policies. The general rules relating to the taxation of annuities and insurance policies are discussed later in this chapter, in connection with Sec. 22(b)(2).

Sec. 29.22(a)-13—Cancellation of indebtedness. The first paragraph of this section contains several rules relating

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The basis of an asset is the amount that is deducted from the proceeds of sale in determining the gain or loss on a sale; and it is also the amount that may be recovered tax-free through depreciation deductions. If property were always purchased for cash, the word "cost" could be used. But property is acquired in many ways other than by purchase, and the "basis" of the property varies, depending on the method by which it was acquired. In some cases property is acquired without cost, as by gift or inheritance. In other cases, although there is a "cost", that cost may differ from the tax basis. For example, if an employee is given an option by his employer to buy stock at $40 a share and exercises the option at a time when the stock is selling for $50, he might think of his "cost" as $40, the amount of cash he actually paid out. But his "basis" for the stock would ordinarily be $50 —the $40 paid in cash plus the $10 he saved because of the option, which amount he has to include in his taxable income.

The original basis of an asset is called the "unadjusted" basis. As the asset is held over a period of time the basis is *adjusted,* as for example, decreased for depreciation or increased if additional capital costs are incurred with respect to it; the basis is then called the "adjusted basis".

to the cancellation of indebtedness and states generally that such cancellation *may* result in taxable income. If, for example, A owes B $1,000 and renders services to B in consideration of which B cancels the debt, A has received compensation for services just as clearly as though B had paid him $1,000 in cash and A had then paid off the debt. The next rule contained in the Regulations is not quite so self-evident. It states that a taxpayer realizes income by the payment or purchase of his obligations at less than their face value—which is, of course, a form of partial debt cancellation. This rule stems from the *Kirby* case.* In that case a corporation issued its bonds at par and later purchased some of them in the open market at less than par; the Supreme Court held that the corporation had realized income to the extent of the difference between the face value of the bonds and the purchase price since there was an increase in the net assets of the corporation.

Although the *Kirby* case is still law, the general doctrine has been modified to a large degree by subsequent case law; and the statement in the Regulations is far too broad. Thus, under present case law, if a debtor discharges his obligations at less than their face value and if he is insolvent both before and after the discharge, he does not realize income. If he is insolvent before but solvent after the discharge he realizes income (if at all) only to the extent to which the discharge made him solvent.** Also, under the rule of the *Hirsch* case † no income is realized if a purchase money obligation is revised downward to the level of the then fair market value of the property purchased and the debt cancelled upon the payment of the lower figure. In the *Hirsch* case, the taxpayer had a purchase money mort-

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* United States v. Kirby Lumber Co., 284 U. S. 1 (1931).

** There are special rules relating to the discharge of indebtedness in proceedings under the Bankruptcy Act which are not discussed.

† Hirsch v. Commissioner, 115 F.2d 656 (C.C.A. 7th 1940).

gage on his property of $10,000 and, at a time when the property was worth only $8,000, made a settlement with the mortgagee whereby the mortgage was cancelled upon the payment of $8,000. The court held that he did *not* realize income of $2,000; rather, the transaction was treated as a reduction of the purchase price.

There is an even more important, and more recent, exception to the theory that a discharge of indebtedness results in income. This is the principle enunciated by the Supreme Court in the *American Dental* case.* In that case the Supreme Court said that if a creditor forgives a debt gratuitously and without consideration the cancellation amounts to a *gift* to the debtor and is not income. The fact that the motives leading to the cancellation might have been business or selfish ones, rather than any desire to benefit the debtor, was held not to be significant. It is obviously difficult to reconcile the *Kirby* case and the *American Dental* case. The Tax Court has recently attempted the following reconciliation, or distinction: if the debtor deals with his creditors in effecting a partial cancellation of the debt, the *American Dental* rule applies; if, however, he buys in his obligations in the open market, the *Kirby* case applies. In the latter situation the *Kirby* case is held to apply because there are no dealings between the debtor and creditor to support the concept of a gift.** It is also interesting to note that although the *American Dental* case held that the discharge of indebtedness was a gift the Treasury has never yet assessed a gift tax against this type of forgiving creditor.

There is one further rule with respect to the cancellation of indebtedness which is contained in Sec. 22(b)(9) of the Code, discussed below at page 40.† Generally, it provides

* Helvering v. American Dental Co., 318 U.S. 322 (1943).

** The Supreme Court has recently granted certiorari in the Jacobson case (Commissioner v. Jacobson, 164 F.2d 594 (C.C.A. 7th 1947)) which involves this question.

† This provision was originally enacted in 1939 as a temporary provision

with respect to *corporations* that the amount of certain debts cancelled shall not be included in income if the corporation complies with the provisions of that section and the Regulations thereunder. The main requirement is that the corporation must reduce the basis of its assets by the amount of income attributable to the discharge of the indebtedness. The question, of course, arises of the relationship between this section and the rule of the *American Dental* case: if the cancellation of the indebtedness is a gift, is there any need to use the provisions of Sec. 22(b)(9)? This question has not yet been finally answered by the courts.

This same section of the Regulations also provides that if a stockholder forgives the principal amount of a debt owed him by a corporation the transaction is ordinarily a contribution to the capital of the corporation rather than income to the corporation.

Sec. 29.22(a)-14, dealing with the creation by corporations of sinking funds to secure indebtedness, is not discussed.

Sec. 29.22(a)-15—Acquisition or disposition by a corporation of its own capital stock. The rules of this section must be distinguished from those of Sec. 29.22(a)-13 dealing with the acquisition by a corporation of its *debt* obligations at less than face value. No gain or loss results, of course, upon the original issue of stock. When, however, a corporation acquires, or acquires and later disposes of, its own stock, gain or loss may result. The Regulations state that whether the acquisition or disposition of the stock results in gain or loss depends on the real nature of the transaction; and

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to assist insolvent corporations in readjusting their indebtedness; it has, however, been regularly extended and in 1942 it was made applicable to all corporations; it is now due to expire on December 31, 1949.

that if a corporation deals in its own shares in the same way that it might deal in the shares of another corporation taxable gain or loss does result. For example, if corporation A buys some of its own shares, holds them for a time as treasury stock, and later sells the shares in the open market, the sale will result in gain or loss just as it would if corporation A had bought and sold the shares of corporation B. The gain in this type of transaction results from the *sale*, not from the purchase, just as in any other purchase and sale of stock. (When a corporation buys in its own *debt* obligations at less than par, under the rules of Sec. 29.22(a)-13, discussed above, it is the purchase itself which may sometimes result in income.)

If, however, a corporation purchases and later sells its own shares for the purpose of adjusting its capital structure it is not dealing in its own shares as it might in the shares of another corporation and the transaction does not give rise to gain or loss. The question in all cases is whether the transaction is actually a capital readjustment or whether the corporation is dealing in its own shares as it might in the shares of another. In answering this question, the Treasury and the Circuit Courts have tended to treat most of these transactions as taxable ones, even in many cases where the corporation had a special purpose in purchasing and selling its shares which purpose could not have been accomplished by the purchase and sale of the shares of another corporation.

While no gain or loss is realized on the mere purchase by a corporation of its own stock for cash, if a corporation receives its own stock in payment of a debt, or as consideration on a sale or exchange of other assets, the stock is treated, under this section, just as any other property which might be received in such a transaction; the stock is valued at its fair market value and income or gain or loss is determined in the same way it would be if cash instead of stock had been received.

Sec. 29.22(a)-15

Sec. 29.22(a)-16, dealing with additional capital contributed by stockholders to a corporation, is not discussed.

Sec. 29.22(a)-17—Sale and purchase by corporation of its bonds. This section reiterates the rule of Sec. 29.22(a)-13 that if a corporation purchases its bonds at a price less than the issuing price or face value the difference is income; and also states the converse rule that if a corporation purchases its bonds at a price in excess of the issuing price or face value the difference is a deductible expense. This section also states the rules for the tax treatment of any premium or discount on the issuance of corporate bonds and the further rules to be applied if the corporation later purchases such bonds at a price either greater or less than the issue price adjusted for any amortized premium or discount. These rules are not discussed.

Secs. 29.22(a)-18, 29.22(a)-19 and 29.22(a)-20, dealing respectively with the sale of capital assets by a corporation, income to a lessor corporation from leased property, and the gross income of a corporation in liquidation, are not discussed.

Sec. 29.22(a)-21—Trust income taxable to the grantor as substantial owner thereof. This is an extremely important and extremely complicated section. It has only recently been added to the Regulations and sets out the rules for the taxation of the trusts known as *Clifford* trusts. The income of these trusts is taxed to the grantor of the trust under the general provisions of Sec. 22(a) of the Code and on the basis of the grantor's control over or power of disposing of the trust corpus or income. Since these *Clifford* trusts are closely related to the trusts taxed under Sec. 166 and Sec. 167, the discussion of this section of the Regulations is postponed to Chapter 8 where it follows the discussion of the Sec. 166 and Sec. 167 trusts. **Sec. 29.22(a)-22** deals with a

related problem of trust taxation and its discussion is also postponed to Chapter 8.

This brings to an end the sections of the Regulations under Sec. 22(a). There are, however, a few general rules relating to specific items of gross income listed in Sec. 22(a) of the Code and not covered by the Regulations which should be pointed out; there is also one problem already referred to—that of the assignment of income—which needs to be further discussed.

Sec. 22(a) of the Code lists interest, rent and dividends as gross income items. Interest is included in gross income unless it is one of the types of tax-free interest which is excluded under Sec. 22(b), discussed below. Rents are included in gross income but if the lessee has an option to purchase payments made after the exercise of the option will ordinarily be treated as part payments of the purchase price rather than as rent. If a landlord receives a lump sum payment upon the cancellation of a lease, the full amount has to be included in income as rent in the year it is received; the lump sum payment is treated as a substitute for the future rental payments.

Dividends are included in gross income, but a distinction in the method of taxation is made between ordinary dividends and distributions in liquidation of a corporation. The important questions here are what types of distributions by a corporation are "dividends" within the meaning of the Code; what types of distributions are distributions in liquidation rather than ordinary dividends; and, if a dividend is a stock dividend, what types of stock dividends are taxable. Those questions are discussed in Chapter 7 in connection with Sec. 115.

Assignment of Income. The problems connected with the assignment of income were referred to briefly at the beginning of this chapter. Most of the cases and most of the

learning on assignment of income have involved assignments by husband to wife. The new income-splitting provisions of the 1948 Revenue Act removed the incentive for assignment in that situation and it may be that future cases will not present the same number of ingenious efforts to accomplish that purpose. The problem is still important, however, in connection with the assignment of income to anyone except a husband or wife.

The present law in relation to the assignment of income has developed entirely through case law and the rules are not set out in the Code or the Regulations. The fundamental question involved in those cases is not whether a particular item is taxable income but who is liable for the tax. The problem arises because of the fact that the income tax rates are progressive. If, for example, a father with a substantial income can succeed in having a part of the income taxed to his son (who has no other income), the total tax is far less than it would be if all the income were taxed to the father.

The two general rules that have been developed are (1) that the asignment of income itself has no tax effect and the assignor remains taxable on the income; and (2) that the transfer of income-producing property (if a bona fide and complete transaction) does have a tax effect and the income from the property will thereafter be taxed to the other person.

In the early case of *Lucas v. Earl* * a husband had entered into an agreement with his wife whereby he assigned to her one-half of his *future* earnings; the Supreme Court held that the husband remained taxable on the full amount of the earnings. In a later case, the *Eubank* case,** a husband had assigned to his wife income that had already been earned by him but not yet received and the Supreme Court

* 281 U.S. 111 (1930).

** Helvering v. Eubank, 311 U.S. 122 (1940).

held that this income from services previously rendered also remained taxable to the husband. In another case not dealing with income from personal services, the *Horst* case,* a taxpayer detached interest coupons from bonds he owned and transferred them to his son just prior to their maturity; although the interest was received by the son, it was held to be taxable to the father. When income from personal services is involved the general rule is sometimes stated that the person who performs the services is taxable on the income. While this is true, there is a more fundamental rule that has been developed by the assignment of income cases and which applies to the assignment of all types of income. This is the doctrine that the person who is entitled to receive income and who, therefore, has the power to control it and dispose of it as he wishes is taxable on it. An assignment of the income itself, therefore, has no tax effect. The effect of the transaction is deemed to be just the same as though the taxpayer had first received the income and had then paid it over to the assignee.

When income is derived from property, however, it is possible for a taxpayer to transfer the *property* to another person and thereby succeed in having the subsequent income taxed to the other person. The transfer must, however, be bona fide and complete so that the taxpayer actually parts with all interest in the property, and no longer has any right to receive the benefit of the income or any power to dispose of it. For example, if a taxpayer makes a completed gift of securities, or any other income-producing property, to his son, and retains no control over the property, the income will thereafter be taxed to the son.

In many cases a difficult question arises whether a taxpayer has merely assigned income or has transferred income-producing property. A life interest in a trust is, of course, property and it was held in the *Blair* case ** that

* Helvering v. Horst, 311 U.S. 112 (1940).

** Blair v. Commissioner, 300 U.S. 5 (1937).

when a taxpayer assigned his entire life interest in a trust the income was thereafter taxable to the assignee. When, however, the life beneficiary of a trust assigned to her children the income of the trust for just one year, the Supreme Court held, in the *Schaffner* case,* that the income remained taxable to the life beneficiary; the assignment was not equivalent to a *substantial* transfer of the corpus of the trust since the life beneficiary retained for herself the general ownership of the life interest. The Tax Court has recently held that an assignment of an interest in a trust for a period of ten years came within the rule of the *Schaffner* case and that the income remained taxable to the assignor.**

A development of the last few years in connection with assignment of income has been in the family partnership field. Since the enactment of the 1948 Revenue Act allowing income-splitting by husband and wife this problem is of less importance, though it still exists with respect to children or other relatives or family trusts that are made partners in a business. In many cases a husband has made his wife (or his minor child or a family trust) a partner in his business under a partnership agreement that is perfectly valid under local (state) law. In many of those cases the wife has contributed no substantial services to the partnership and no capital of her own, her interest being received as a gift from her husband, and she has had no managerial control over the business. The Supreme Court has held (in the *Tower* and *Lusthaus* cases †) on facts similar to those above that the partnership would not be recognized for tax purposes and that the wife's share of the income was taxable to the husband. The partnership agreement is held to be no more than a method of re-allocating income within a family group. The tax law as to family partnerships is still

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* Harrison v. Schaffner, 312 U.S. 579 (1941).

** Leonard Farkas, 8 T.C. 1351 (1947). (Reversed)

† Commissioner v. Tower, 327 U.S. 280 (1946); Lusthaus v. Commissioner, 327 U.S. 293 (1946).

in an unsettled stage but at the present time the new partner will not be recognized as a partner for tax purposes unless he contributes capital of his own or renders substantial services to the partnership. The question of how much capital or how substantial services the new partner must contribute before the partnership will be recognized is one to which there is no clear answer at the present time.

Sec. 22(b) (Exclusions From Gross Income) lists in its various subsections certain items that are not, in whole or in part, or under certain circumstances, included in gross income. Each subsection is discussed separately in its numerical order.

Sec. 22(b)(1) (Life Insurance) excludes from gross income the proceeds of life insurance if the proceeds are received by reason of the death of the insured. In this connection it should be remembered that the taxpayer cannot deduct the premiums that are paid on the policy, so that in the ordinary case when the proceeds are paid upon death neither the premiums paid nor the proceeds of the policy enter into the tax return.

Sec. 22(b)(2)(A) (Annuities, Etc., in General) states several rules relating to insurance. The first sentence covers amounts received under a life insurance or endowment policy (1) *not* paid by reason of death and (2) *not* an annuity, as, for example, amounts received under an endowment policy or upon the surrender of a life insurance policy; these amounts are income to the extent that they exceed the cost (ordinarily the premiums paid) of the policy.

The second sentence covers the taxation of annuities. When a taxpayer buys an annuity contract and later receives annuity payments, a part of each payment represents

interest which is taxable and a part represents a return of the cost of the annuity which should not be taxed. This section lays down an arbitary rule for determining the amount of the payments received in each year which are to be excluded from income. The rule can be understood more easily through an example than through a general statement of the Code provision. Assume that a taxpayer purchased an annuity contract at a cost of $10,000 and received an annual annuity of $800. He would include in income each year 3% of the total cost, or $300; this is assumed to be interest on the amount invested in the policy. He would then exclude the balance of $500 each year since this is considered a return of his cost. If he lived long enough to have excluded over the years the full cost of $10,000, he would thereafter include the entire annuity payment in income. This rule implies an interest rate of 6% which is obviously excessive, and under the present formula few annuitants ever live long enough to recover their entire cost tax-free.

The balance of the section deals with transfers for a valuable consideration of life insurance, endowment or annuity policies. The general rule in such cases is that the person who buys the policy and later receives the proceeds includes in income all of the proceeds that are in excess of the sum of the consideration paid on the purchase and any premiums subsequently paid by the purchaser. There are certain exceptions to this rule stated in the last two sentences of the section which should be examined but which are not discussed here.

Sec. 22(b)(2)(B) (Employees' Annuities) deals mainly with annuities purchased by employers for their employees either under an employees' group annuity plan or for individual employees not under such a plan. This section is tied in so closely with Sec. 23(p) and Sec. 165, dealing with employees' pension and profit-sharing plans, that it is not

discussed here. A brief discussion of the entire subject is contained in Chapter 8.

Sec. 22(b)(3) (Gifts, Bequests, Devises and Inheritances) excludes from gross income amounts received by gift, bequest, devise or inheritance. It has been pointed out earlier that because gifts are not subject to income tax it becomes very important at times to determine whether a particular item is a gift or not. The question arises most frequently in connection with payments to employees and in connection with a cancellation of indebtedness.

The first sentence of this section means only that if property is received by gift * the property itself is not income to the donee. Under the second sentence, any income from the property is included in the donee's income. That is, if A gives B $10,000 worth of securities, the securities themselves are not income to B; but any dividends or interest later received on the securities are income. The same sentence also provides that if the gift or bequest, etc., is of income from property the amount of the gift is not excluded from gross income. If, for example, A gives property to B for life with remainder to C, the income during B's life is taxable to B even though it was received by gift. The reason for this rule is that otherwise the income would go entirely untaxed.

This section also contains the rule for determining whether a gift is a gift of property itself or of income from property. The rule is that when payment of the gift is to be made at intervals (not in a lump sum) the gift is to be treated as a gift of income (and therefore taxable) to the extent it is paid out of income. For example, a bequest of an annuity of a specific annual amount, which is to be paid from the income of a trust but is to be a charge against the

* The terms "gift" and "donee" are used in this section of the text for convenience, to mean, respectively, any amount received by gift, bequest, devise or inheritance, and the person receiving such amount.

corpus of the trust if the income is insufficient, would be treated as a gift of income (taxable) to the extent that it was paid out of income.

Sec. 22(b)(4) (Tax-free Interest) provides the rules with respect to interest that is either entirely or partially tax-free. Interest on state and municipal bonds and other obligations is entirely tax-free. Interest on the obligations of the United States or of instrumentalities of the United States issued prior to March 1, 1941 is tax-free to the extent provided in the statutes under which the obligations were issued. This means that in some cases the interest is entirely tax-free, in some is exempt from normal tax but not from surtax, and in some cases is entirely taxable. Interest on all obligations of the United States or its instrumentalities issued on or after March 1, 1941 is entirely taxable. The Tax Services provide tables showing the taxable status of the interest on federal obligations issued prior to March 1, 1941. One point that should be kept in mind in connection with tax-exempt securities is that the exemption extends only to the interest on the securities; if the securities are sold at a gain, the gain on the sale is not exempt but is taxable as a capital gain.

For many years different groups have urged the repeal of the tax-exemption granted to the interest on state and municipal securities but so far without success. With the present high tax rates, this exemption gives an enormous preference to those securities. For an individual in an 80% tax bracket, for example, an investment in a tax-exempt obligation paying 2% provides the same net return as an investment in a taxable obligation paying 10%.

Sec. 22(b)(5) (Compensation for Injuries or Sickness) excludes from gross income amounts received under accident or health insurance, or received under workmen's compensation acts, as compensation for personal injuries or

sickness; it also excludes any damages received for such injuries or sickness. It does not matter whether the damages were received by suit or in accordance with an agreement. Personal injuries, as here used, include injury from libel, slander or for breach of promise to marry.

The first clause of the section excludes from its coverage any amounts received which are attributable to deductions for medical expenses taken in a prior year under Sec. 23(x).* If, for example, a taxpayer had deducted $500 in 1947 as a medical expense resulting from an accident and then, under a settlement agreement, recovered his medical expenses in 1948, $500 of the amount received would have to be reported as income in 1948. This is because the taxpayer has had the benefit of the deduction in 1947, so that the later inclusion of the recovery in income merely brings him out even, taxwise. This provision is a good example of a general rule that is discussed later in this chapter—that when an amount deducted in one year is recovered in a later year the recovery is income. There is an important modification of this provision, discussed at page 43, to the effect that the recovery is income only if and to the extent that the deduction gave the taxpayer a tax benefit in the prior year.

Sec. 22(b)(6) (Ministers), Sec. 22(b)(7) (Income Exempt Under Treaty), and Sec. 22(b)(8) (Miscellaneous Items) are not discussed.

Sec. 22(b)(9) (Income From Discharge of Indebtedness) deals with a type of income discussed earlier in this chapter —the income that is deemed to result under the rule of the *Kirby* case when a taxpayer discharges a debt by the payment of less than its full amount. This section provides that the amount of the debt cancelled shall *not* be included in income under certain specified circumstances. The section

* The medical expense deduction is discussed in Chapter 3.

refers only to the indebtedness of corporations, not of individuals; and only to indebtedness that is evidenced by a security, defined to mean any bond, debenture, note, certificate or other evidence of indebtedness issued by a corporation. The section and the Regulations thereunder provide that, if the taxpayer is a corporation and if the indebtedness is evidenced by a "security", the income attributable to the discharge of the debt shall *not* be included in gross income if the taxpayer agrees to reduce the basis of its assets by the amount excluded from gross income.

The purpose of this provision is to relieve corporate taxpayers whose debts have been cancelled, or partially cancelled, from having to pay an immediate income tax on the amount of the cancellation. The effect of the provision is, however, to postpone rather than to eliminate a tax. Assume, for example, that a corporation has just one asset with a basis, before the adjustment under this section, of $100,000. It buys in its bonds with a face value of $20,000 for $15,000. Except for this section, the difference of $5,000 *might* * be income, and taxable at ordinary income rates. Under this section, however, the corporation would not report the $5,000 as income but would reduce the basis of its asset by $5,000 to $95,000. If the asset was later sold for $100.000 (and there were no other basis adjustments) there would be a taxable gain of $5,000 at the time of the sale.** If the asset was never sold, and was a depreciable asset, the amount that could be recovered tax-free through depreciation deductions would be $5,000 less than it would have been without this adjustment.

To obtain the benefits of this section, the taxpayer has to file with its return its consent to the Commissioner's regulations contained in Regs. 111, Sec. 29.113(b)(3). Those

* If the American Dental case is controlling, it would not be income but would be a gift.

** This gain would, however, under most circumstances, be taxed at the capital gain rate—see Chapter 7.

Regulations provide in considerable detail the method by which the basis of the assets is to be adjusted. In general, the adjustment to the basis of the corporation's assets is to be made in the following order: (1) any specific property if the indebtedness was incurred to purchase that property; (2) any property (except inventory or notes and accounts receivable) against which there was a lien; (3) all other property except inventory and receivables; (4) inventory and notes and accounts receivable.

Sec. 22(b)(10) (Income from Discharge of Indebtedness of a Railroad Corporation) is not discussed.

Sec. 22(b)(11) (Improvements by Lessee on Lessor's Property) was added to the Code by the 1942 Revenue Act in order to exclude from gross income a certain type of income about which there had been a great deal of controversy and litigation. That is the income derived by a lessor of real property when, upon the termination of a lease, he receives back the real property together with buildings or other improvements which were erected or made by the lessee. There is certainly profit to the lessor if he leases land, the lessee erects a building, and at the termination of the lease the lessor gets back both the land and the building. This was always recognized but, prior to 1942, a controversy existed with respect to the year when the lessor realized the income and when he should be taxed. Did he realize it in the year the building was erected, or in the year the lease was terminated, or should the income be pro-rated over the entire period of the lease? Another difficulty was that, if the lessor was held to realize the income in any of those periods, he would have a tax to pay at a time when he had received nothing in the form of cash or disposable property out of which to pay the tax.

The statute now solves the problem by providing that no amount is to be included in gross income on account of any

income derived from buildings erected or improvements made by a lessee. As is true of many provisions of the Code, however, the tax on this profit is not entirely eliminated but is merely postponed through the operation of the corresponding basis section—Sec. 113(c). This latter section provides that the basis of the real property of the lessor shall *not* be increased by any income derived by the lessor from improvements which income is excluded from gross income under Sec. 22(b)(11). Thus, this income which is excluded from gross income is (or may be) taxed if the property is later sold. Assume that the real estate without the improvements had a basis of $50,000 and that the improvements had a value of $10,000; the basis of the real estate is *not* increased so that if the lessor sells the property for $60,000 (and there are no other basis adjustments) he will be taxed in the year of sale on the gain of $10,000 (which presumably resulted from the improvements).*

Sec. 22(b)(12) (Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts) provides a modification of the general rule applicable to the recovery of items deducted in a prior year. The general rule is that, if an amount has been deducted ** from gross income in one year and is recovered in a later year, the amount recovered is income in the later year. If, for example, a taxpayer deducts $500 in 1947 as a bad debt and in 1948 the debtor unexpectedly comes into funds and repays the debt, the taxpayer must include the $500 in income. The effect is that, except for differences in tax rates, the entire transaction is a wash.

This general rule is not explicitly stated anywhere in the Code. The modification of the rule, contained in this section,

* But this gain would ordinarily be taxed as a capital gain rather than as ordinary income.

** The same rules apply if the amounts were taken as credits (see Chapter 4) rather than as deductions.

provides that, if the deduction in the earlier year did not result in a tax benefit to the taxpayer, the amount subsequently recovered (called in the Code the "recovery") is not included in income. This is ordinarily called the "tax benefit rule". If, in the preceding example, the taxpayer had had a net loss in 1947 (before deduction of the bad debt), the bad debt deduction would not have resulted in any tax benefit since he would have had no tax to pay even without the deduction; the recovery in the later year would, therefore, not have to be included in income. If the deduction in the earlier year resulted in a partial but not a full tax benefit, the recovery is included in income only to the extent there was a benefit in the earlier year. Referring to the previous example, if the taxpayer had had in 1947 taxable income of $300, before the bad debt deduction, the deduction would have benefited him only to the extent of $300; only $300 of the recovery would then be included in income in the later year.

The section is worded in terms of the amount of the recovery that is *not* included in income; the taxpayer *excludes* the recovery from gross income to the extent of the "recovery exclusion". The "recovery exclusion" is, in effect, the amount of the deduction in the earlier year that did not result in a tax benefit to the taxpayer; in the last example in the preceding paragraph, the "recovery exclusion" is $200.

It will be noticed that this section refers only to the recovery of a bad debt, or a tax, or a "delinquency amount" * deducted in an earlier year. The Regulations (Sec. 29.22-(b)(12)-1), however, because of the decision of the Supreme Court in the *Dobson* case,** have extended the provisions

* A "delinquency amount" is an amount which has been paid or accrued because of the failure to file a return or to pay a tax on the due date, and which was allowed as a deduction or credit, *e.g.*, interest upon delinquent taxes.

** Dobson v. Commissioner, 320 U.S. 489 (1943).

of this section to the recovery of all other "losses, expenditures, and accruals" which were deducted or taken as credits in earlier years, *except that* the section does *not* apply to amounts previously deducted for depreciation, depletion, amortization, or amortizable bond premium. As an example of the exception, assume that a taxpayer owns a building with an original cost of $100,000 on which the proper depreciation rate was 3% a year or $3,000; he has owned the building for five years at the end of which time the basis, adjusted for depreciation, is $85,000; all five years were loss years in which the depreciation deduction resulted in no tax benefit; at the end of the five-year period he sells the building for $100,000, or at a gain of $15,000 over the adjusted basis. If the general rule of Sec. 22(b)(12) applied, this $15,000 would represent the recovery of amounts deducted in earlier years (depreciation) which had not resulted in a tax benefit; because of the exception, however, the tax benefit rule does not apply, and the full gain of $15,000 is included in income.

Sec. 22(b)(13) (Additional Allowance for Military and Naval Personnel) and Sec. 22(b)(14) (Mustering-out Payments for Military and Naval Personnel) are not discussed.

Those two subsections are the last of the subsections under Sec. 22(b). Sec. 22(b) contains most of the provisions relating to items that are excluded from gross income; there are, however, a few other items that are excluded under Sec. 116 discussed in Chapter 7.

Sec. 22(c) (Inventories) and Sec. 22(d) (Method Used in Inventorying Goods), which prescribe the rules for the use of inventories in determining gross income, are discussed only briefly.

Sec. 22(c) merely states that, when inventories are neces-

sary in order clearly to determine the income of a taxpayer, the inventories shall be taken upon such basis as is prescribed by the Commissioner as conforming to the best accounting practice, and as most clearly reflecting the income. The Regulations under Sec. 22(c) provide that inventories *are* necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor. Inventories are ordinarily taken at either (1) cost, or (2) cost or market, whichever is lower, and a taxpayer may adopt either method. However, once a method is adopted, the taxpayer can change the method only after permission is obtained from the Commissioner. Under Sec. 22(c), when goods included in the inventory are so intermingled that they cannot be identified with particular purchases, the goods sold or used in manufacture are deemed to be the goods first purchased, and the goods that remain in the inventory are deemed to be the goods last purchased. This is another example of the "first-in, first-out" rule which was mentioned earlier in connection with sales of stock. Prior to the 1938 Act this first-in, first-out rule of Sec. 22(c) was the only permissible rule in cases where items in the inventory could not be identified with specific purchases.

Sec. 22(d) was added to the Code in 1938 to allow taxpayers, subject to the permission of the Commissioner, to use the converse rule of "last-in, first-out". This is colloquially called the "lifo" rule and means, in general, that the goods sold are deemed to be those last purchased, while the goods remaining in the inventory are deemed to be those first purchased. The main advantage of the "lifo" method is that, in periods of rapidly fluctuating prices, the spread between costs and selling prices is not so great since both costs and selling prices are affected by the same market fluctuations. When the first-in, first-out method is used, goods that have been purchased in a period of low prices may be deemed to be those sold in a higher price period, and vice versa, with the result that income may be greatly dis-

torted by inventory fluctuations. If the "lifo" method is used the taxpayer has to inventory the goods at cost only and cannot use cost or market; he has to apply to the Commissioner for permission to use the method; and, once permission is granted and the method adopted, he must use the method for all subsequent years unless the Commissioner grants his approval to a change to a different method.

Sec. 22(e) (Distributions by Corporations), Sec. 22(f) (Determination of Gain or Loss), Sec. 22(g) (Gross Income from Sources Within and Without United States), Sec. 22(h) (Foreign Personal Holding Companies), Sec. 22(i) (Consent Dividends) and Sec. 22(j) (Income from Mortgages Made or Obligations Issued by Joint Stock Land Banks) are cross reference sections and not discussed.

Sec. 22(k) (Alimony, Etc., Income) was added to the Code by the 1942 Act in order to make alimony payments taxable to the wife rather than to the husband. Prior to the enactment of this section, when a husband paid alimony to his divorced wife he was not allowed to deduct the amounts paid from his gross income; and the wife was not required to report the alimony as income. The theory was that the alimony payments were not income to the wife since they merely discharged the husband's legal obligation of support. From the husband's position, they were a non-deductible personal expense. As a result, it was possible, in the case of high surtax bracket taxpayers, for the amounts paid to the wife plus the tax on the entire income to exceed the husband's total income.

The law has now been changed, and Sec. 22(k) provides that the payments are taxable to the wife in the circumstances specified in that section. Sec. 23(u) is the correlative section relating to the husband and provides that the amounts included in the wife's income under Sec. 22(k) are deductible by the husband. This deduction clause refers to

payments that are made directly by the husband without the interposition of a trust. When a husband sets up an alimony trust, the applicable provisions, which are discussed below, are slightly different.

Sec. 22(k) applies only to payments made to a wife who is divorced or legally separated from her husband, and only to payments received subsequent to the decree. In the case of a separation, this means that there must be a judicial decree of separation. If a wife and husband live apart under a separation agreement only, payments by the husband for the support of his wife are not deductible by him and are not taxable to the wife.

The payments, to be deductible, must be in discharge of an obligation imposed by (1) a decree of divorce or legal separation or (2) a written instrument that is incident to the divorce or separation. Thus, this section applies to payments made after a decree of divorce (or of legal separation) in accordance with a separation agreement between a husband and wife even though the agreement is not incorporated in the divorce decree, if the agreement was made by the parties when they were contemplating divorce and as a part of their settlement.

The section applies only to periodic payments. If a husband makes a lump sum settlement, the amount is not deductible by him and is not taxable to the wife. Since lump sum payments are sometimes made in installments, it is necessary to determine what types of payments are lump sum and what types are periodic. The common form of alimony payments—payable monthly or annually, etc., during the wife's life or until her remarriage—are of course periodic payments. If, instead, the parties agree on a lump sum payable in installments, the payments will still be treated as periodic payments and taxable to the wife *if* they are to be made over a period longer than ten years from the date of the agreement or decree; if, however, the wife receives over 10% of the principal sum in any one year, the

excess over the 10% is not taxable to her (or deductible by the husband) as a periodic payment.

One of the most important points to note about this section is that it does *not* apply to any portion of the payments that is specifically designated as an amount to be paid for the support of minor children; the husband remains taxable on those amounts and they are not included in the wife's income. If, however, the decree or agreement fixes just one amount for the support of the wife and minor children, without specifying how much of the payments are for the support of the children, the husband can deduct, and the wife will be taxable on, the full amount.

As pointed out above, when a husband sets up an alimony trust to provide for the payments instead of making them directly, the applicable Code provisions are slightly different. Prior to the amendments made by the 1942 Act, the income of many alimony trusts was taxable to the husband and was not taxable to the wife. Sec. 22(k) now provides (with respect to trust payments made under a decree of divorce or separation or a written instrument incident to such decree) that the income from an alimony trust shall not be included in the husband's gross income and that all payments, whether out of income or corpus, shall be included in the wife's income. Since the trust income is never included in the husband's gross income, there is of course no need for any provision allowing him to deduct the amount of the payments—this is the reason for the somewhat involved wording of Sec. 23(u).

Sec. 22(k) does not cover payments from a trust created prior to the decree of divorce or separation which payments are not pursuant to the decree or to a written instrument incident thereto. Those payments are covered by Sec. 171, discussed in Chapter 8.

The statute speaks in terms only of amounts paid by a husband to a wife. However, Sec. 3797(a)(17) of the Code provides that the term "husband" shall be read to mean

"wife", and the term "wife" shall be read to mean "husband", whenever payments referred to in Sec. 22(k), Sec. 23(u) and Sec. 171 are made (in the not entirely unknown case) by a wife to a husband.

Sec. 22(l) (Income of Decedents) is merely a cross reference section. **Sec. 22(m) (Services of Child)** is not of general importance and is not discussed. It provides that any amounts received for the services of a minor child, whether received by the parent or by the child, shall be included in the gross income of the child and not of the parent.

Sec. 22(n) (Definition of "Adjusted Gross Income") sets out the items that can be deducted in determining "adjusted gross income". The concept of adjusted gross income is relevant only to the income of individuals, not to that of corporations. In determining the net income of an individual, the first step is to determine the gross income; then the items listed in this section are deducted to determine adjusted gross income; after that the other allowable deductions are subtracted in order to determine net income. The section that sets forth the items that are allowed as deductions is, of course, Sec. 23 which is discussed in Chapter 3. Sec. 22(n) does not provide for the allowance of any *additional* deductions but merely lists those items contained in Sec. 23 that are deductible for the purpose of determining adjusted gross income; the other items contained in Sec. 23 are not deductible in determining adjusted gross income but are deductible in determining net income.

The concept of adjusted gross income is important for only certain purposes, *e.g.*, the allowable charitable and the medical expense deductions. The deduction by an individual for charitable contributions cannot exceed 15% of the adjusted gross income, and the deduction for medical expenses is limited to the expenses in excess of 5% of adjusted gross income (with certain other limitations). Also, the

standard deduction allowed individuals by Sec. 23(aa) is in lieu of all deductions *except* those that are allowed in determining adjusted gross income; in other words, an individual taxpayer can take the deductions allowed by Sec. 22(n) and *also* take the standard deduction.

Employees are allowed, under this section, to deduct only (1) expenses of travel and meals and lodging while away from home, incurred in connection with their employment, and (2) other expenses incurred in connection with their employment for which they are reimbursed by their employers. When expenses are reimbursed, the employee should, technically, include the amount of the reimbursement in income and deduct the expenses; this, of course, results in a wash. Taxpayers other than employees are allowed to deduct under this section (1) deductions attributable to a trade or business, (2) deductions, even though not attributable to a trade or business, if they are attributable to property held for the production of rents or royalties, and (3) losses from sales or exchanges of property. Beneficiaries of a trust and life tenants of property are also allowed to deduct, under this section, the depreciation and depletion deductions allowed them by Secs. 23(l) and 23(m). It should be emphasized again that all the foregoing items are deductible under this section only if they are allowable deductions under Sec. 23 and meet the requirements set out in that section.

CHAPTER 3

SECTION 23 AND SECTION 24

Sec. 23 (Deductions from Gross Income)

Sec. 23 contains twenty-seven subsections dealing with the items that are deductible from gross income in determining net income. It is obviously impossible in a book of this size to set out in detail all the items that can be deducted together with all the limitations and restrictions on the deductions. This chapter, therefore, contains a somewhat general discussion of the subsections dealing with the more important types of deductions, with more attention given to the underlying principles than to specific rules with respect to the deductibility of each particular item. Several of the subsections deal with deduction items which, while important, are of only specialized interest; those subsections are merely pointed out in passing and are not discussed. Sec. 24, as opposed to Sec. 23, sets out specific items that can *not* be deducted; the provisions of that section are discussed in the latter part of this chapter.

Sec. 23(a) (Expenses) which provides for the deduction of business expenses, and also certain non-business expenses, is by far the most important of the deduction sections since the expense deductions are for any business or profit making activity the most important in dollars of any of the deductible items.

The first distinction that needs to be made is between an expenditure that is deductible as an expense and an expenditure that cannot be deducted but has to be capitalized, that is, treated as the cost or part of the cost of an asset. A capital expenditure is ordinarily one that is made in acquiring or improving property that will have a useful life of longer than one year. For example, the cost of acquiring a plant or a production machine would clearly be a capital expenditure. This type of expenditure cannot be deducted all in one year, primarily because the asset will last and be used in the business for longer than one year. The expenditure is charged to the capital account as the cost of

the asset; then, if the property is a depreciable asset (which would be the usual case), the cost is recovered, free of tax, through depreciation deductions that are taken annually over the life of the property. The same rule applies to expenditures which are made, not in acquiring new assets, but for permanent improvements to previously existing assets, such as the cost of a new roof, a new heating plant, additions to a building, new elevators, etc.

It should be noted that capital expenditures for depreciable assets, as well as expense items, are deducted from income at some time; the distinction is that the capital expenditures are deducted, through depreciation deductions, over the period of years during which the assets are used, rather than all in one year.

When repairs are made to property the distinguishing line between a capital expenditure and an expense item is often rather difficult to draw. Small incidental repairs of a type that recur every year are clearly deductible as expenses, but larger items may be improvements rather than repairs. The general rule is that repairs which merely keep property in good working condition and do not materially add to the value of the property or prolong its life are deductible expenses; while repairs or replacements that do prolong the life of property or add to its value are capital expenditures. Capital expenditures are among the specific items not allowed as deductions by the provisions of Sec. 24, and the Regulations under that section (Sec. 29.24-2) list many types of expenditures that have to be capitalized rather than deducted as expense items.

Expenses fall into three main categories:

Paid

1) Expenses incurred in a taxpayer's trade or business, such as the ordinary expenditures of a business for salaries, rent, insurance, advertising, repairs, etc. Profit Motive Necessary

2) Expenses incurred which are not incurred in connection with a trade or business but which are in-

curred (a) in connection with the production or collection of income, or (b) in connection with the management, conservation or maintenance of property which is held by a taxpayer for the production of income. These are called the non-trade or non-business expenses. An example of this type of expense would be salary paid by a taxpayer to an employee who managed his personal investments for him. The investment activities are not considered a trade or business but they are entered into for the production of income so that the expenses incurred in connection therewith can be deducted.

3) Expenses that are purely personal. This category includes all expenses that are not included within the terms of 1) and 2) above.

Returning to the Code, Sec. 23(a)(1) allows the deduction of the first type of expenses—trade or business expenses. Prior to 1942, expenses of the second type were not allowed as deductions. This was clearly unfair. The investor in the example above had to pay tax on any income he received from his transactions but could not deduct his expenses so that he was taxed on the gross income rather than on the net income from the transactions. This situation was corrected by the 1942 Act which added Sec. 23(a)(2) to the Code and allowed the deduction of expenses of the second type. Expenses of the third type, purely personal expenses, are, with the exception of extraordinary medical expenses, not allowed as deductions. This is specifically provided by Sec. 24(a)(1) which is discussed later in this chapter.*

* Interest and taxes are allowed as deductions even though they are purely personal; these items, however, while they might be considered as personal expenses, are specifically allowed as deductions under later subsections of Sec. 23 and not under the expense section. The classification used in the Code is followed in the text and interest and taxes are treated as not falling within the category of expenses.

Sec. 23(a)(1)(A) (Trade or Business Expenses—in General) is the most important of the expense sections. The main requirements stated in this section are that the expenses must be "ordinary and necessary"; must be "paid or incurred during the taxable year"; must be connected with the carrying on of a "trade or business"; and, if the expenses are for salaries, the salaries must be "reasonable" and in payment for personal services actually rendered.

Ordinary and Necessary. Expenses, to be deductible, must be both ordinary *and* necessary. While most expenses of a business would be both ordinary and necessary since otherwise they would not be made, certain types of expenses may be disallowed on the ground that they are either not ordinary or not necessary. In a leading case, *Welch v. Helvering,** for example, a taxpayer had been an officer of a corporation that had gone into bankruptcy; he later went into business for himself, dealing with some of the creditors of the bankrupt corporation as his customers; and to establish his own credit he personally paid a part of the debts of the company that had been discharged in the bankruptcy proceedings. The Supreme Court held that those payments were not deductible since, although they might have been necessary in establishing the taxpayer's credit, they were not ordinary in the sense of being expenditures that most taxpayers in the same situation would have made.

There has been a great deal of litigation over the question of what are ordinary and necessary expenses but no general rules can be laid down, since what is ordinary and necessary depends on the type of business of the taxpayer and the business customs at the time and in the locality where the taxpayer is operating. It is not necessary that the expense should be ordinary in the sense that it is one

* 290 U.S. 111 (1933).

frequently made by the taxpayer; in fact, the question most often arises in connection with non-recurring expenses. The expenditure must, however, be ordinary in the sense that, for the group or community of which the taxpayer is a member, it is a normal response to the particular exigency.

Certain expenditures are not deductible because their allowance would be against public policy. Thus, fines and penalties are not deductible both because it would be against public policy to allow the deduction and because the payment of a fine or penalty is not an ordinary and necessary business expense. Under this rule, penalties paid in connection with federal or state income taxes are not deductible. However, expenses such as attorneys' fees incurred in defending a civil action based on an illegal act are deductible, provided the suit arises out of matters connected with the taxpayer's trade or business. And expenses incurred in defending a criminal action may also be deductible, even though the defense is unsuccessful, if the suit arises out of matters connected with the taxpayer's trade or business and the allowance of the deduction is not against public policy.

Paid or Incurred During the Taxable Year. The phrase "paid or incurred" in Sec. 23(a)(1)(A) refers to the accounting method of the taxpayer. If a taxpayer is on a cash basis, he deducts expenses in the year in which they are paid. If he is on an accrual basis, he deducts expenses in the year in which they accrue, which is the year when the liability to pay becomes fixed and certain and the amount of the liability can be estimated. Those rules apply not only to expense items but to all deductible items. The question of the year in which a deduction can be taken is often extremely important both because the tax benefit resulting from the deduction will be much greater in a year when the taxpayer is in a high surtax bracket, and because the deduction may be lost entirely if it is not taken

in the right year. The question of the right year in which to take deductions is discussed in Chapter 4 in connection with Sec. 43 and is referred to from time to time in this chapter in connection with the deduction of particular items.

Trade or Business. The phrase "trade or business" cannot be rigidly defined; but the two most important requirements are that the activity must be one entered into with at least the *expectation* of making a profit (as opposed to a pure hobby), and that there must be some regularity and continuity in the activity. The question whether an expense is incurred in connection with a trade or business does not often arise in connection with corporations since normally all of a corporation's expenses are incurred in connection with its trade or business. Prior to 1942, the question was extremely important in connection with individuals since at that time expenses incurred in profit-making activities could not be deducted if the activities did not constitute a trade or business. Since 1942 the question is of much less importance in connection with the *expense* deductions of individuals since many of the non-trade or non-business expenses are now deductible under Sec. 23(a)(2).

The question of what constitutes a trade or business is still important, however, in connection with certain other sections of the Code, such as Sec. 117, under which the treatment of gains and losses from sales of property varies depending on whether the property was used in a trade or business or whether the sales were made in the course of a trade or business; and Sec. 122, under which deductions not attributable to the operation of a trade or business are not allowed for the purpose of computing the net operating loss carry-over. A few general rules can be stated. It is well settled, as stated above, that there must be a certain amount of continuity and regularity in connection with the activities before they will constitute a trade or business. Where sales are concerned, one or two sales will not make

a business. However, it has been settled that a taxpayer can be engaged in more than one trade or business; a taxpayer can, for example, be engaged in a manufacturing business and also be in the business of selling real property. For a long time there was a great deal of litigation over the question whether an individual who held just one piece of property as rental property was engaged in a trade or business or merely held the property as an investment. The Commissioner has now accepted the position maintained by the Tax Court that such an individual is engaged in a trade or business. On the other hand, it was held by the Supreme Court in the *Higgins* case * that even very substantial trading activities in the securities markets on the part of an individual did not constitute a trade or business. It was that decision that led to the enactment of Sec. 23(a)(2) allowing the deduction of expenses related to the production of income even though the taxpayer's activities did not constitute a trade or business.

It is also necessary, of course, that the expenses should be incurred in the *taxpayer's* trade or business and not in the trade or business of another; the requirements that the expenses must be ordinary and necessary and incurred in a trade or business both imply that the expenses must be the taxpayer's expenses. The case of *Deputy v. Du Pont* ** was decided on this principle. In that case, the taxpayer who was a large stockholder in the Du Pont Company acquired additional stock of the company in order to sell it to certain company executives, and incurred expenses in connection with the transaction. The sales were made in furtherance of an incentive plan of the company to give management a larger stake in the business; the plan, if successful, would of course also have operated to benefit the taxpayer by increasing the value of his stockholdings. The Supreme

* Higgins v. Commissioner, 312 U.S. 212 (1941).
** 308 U.S. 488 (1940).

Court held that the expenses were not deductible by the taxpayer since they were incurred, not in connection with *his* trade or business, but in connection with the trade or business of the company.*

Reasonableness of Salaries. The special additional requirement with respect to salaries is that only a *reasonable* amount paid as compensation for personal services actually rendered can be deducted. There are innumerable cases dealing with the reasonableness of salaries but most of them have arisen in connection with either closely held corporations or sole proprietorships or partnerships where the salaries were paid to stockholder-employees or stockholder-officers or to relatives or friends. There is an obvious tax saving if a closely held corporation pays out its earnings in the form of salaries to its stockholders who are also employees or officers rather than paying them out in the form of dividends; the dividends are not deductible in determining the corporation's taxable income while the salaries are (or are hoped to be) deductible. There is also an obvious tax advantage if salaries are paid by an individual business proprietor to a son or other relative whom the taxpayer wishes to benefit since the income is kept within the family group but, because it is broken up into several piles, is taxed at lower surtax rates.

In determining whether salaries are reasonable a great many factors are taken into account. Among the more important are: the nature of the services rendered; the sal-

* The principle of the Du Pont case has since been applied where a stockholder claimed a similar expense as a non-trade or non-business deduction under Sec. 23(a)(2). Expenses to be deductible under that section must still be ordinary and necessary in the sense of being the type of expenses that would ordinarily be incurred by a person in the taxpayer's position. Most stockholders do not pay expenses that are primarily the expenses of the corporation and, therefore, they cannot take those expenses as a non-trade or non-business deduction. Of course, expenses of this type would be deductible by the corporation if incurred by the corporation rather than by the stockholder.

aries paid in prior years for the same type of work; whether the salary is on a contingent basis—a larger amount may be reasonable if the compensation is contingent; the amount the employee could have obtained from another employer for the same work. If the salaries are paid to employees or officers who are also stockholders, and if the salaries bear a close relationship to the amount of stock owned, the Commissioner can almost be expected to disallow a part of the salary payments on the ground that they represent a concealed distribution of dividends.

However, and this is an important point to keep in mind, when a part or all of an amount paid as salary is disallowed as a deduction to the employer, it does not follow that the employee is not taxed on the full amount. He has received the full amount paid, whether he was an employee receiving excessive compensation or a stockholder-employee receiving part compensation and part dividend distribution, and he remains taxable on the entire amount received.

Bonuses and commissions are deductible as compensation for personal services subject only to the test of reasonableness applicable to other salary payments. Also, the fact that the deduction for salaries cannot exceed a reasonable amount for services actually rendered does not mean that all of the services for which payment is made must have been rendered in the current year. A salary payment, even though large in amount, which is made in one year for services rendered both in that year and in previous years will be allowed as a deduction if the total payment is not unreasonable in view of the services rendered during the entire period. This situation arises particularly in the case of a new business when nominal salaries are paid during the development years and relatively large salaries paid in a later year, partly in recognition of the previous services.

Traveling and Living Expenses. Sec. 23(a)(1)(A) specifically provides for the deduction by an individual taxpayer of traveling expenses and the cost of meals and

lodging *while away from home* in the pursuit of a trade or business. The controversial question in connection with this provision has been—when is a taxpayer away from "home"? It has been definitely settled that the cost of commuting is not deductible; this cost is a personal expense incurred because the taxpayer prefers to live at some distance from his place of business. It is also well settled that a taxpayer such as a salesman who travels on his employer's business is away from home during his travels and can deduct his expenses for transportation, meals and lodging.

The fact situations which have caused controversy are those similar to the ones in the *Flowers* case * which is the only case of this nature that has gone to the Supreme Court. In that case, the taxpayer lived in Mississippi and was employed as general counsel of a railroad in Alabama; his family continued to live in Mississippi and he himself lived there part of the time and did part of his work there; the rest of the time he lived in Alabama. He claimed a deduction of his traveling expenses between Mississippi and Alabama and his living expenses while in Alabama, on the ground that while he was in Alabama he was away from his home which was in Mississippi. The Supreme Court held that he could not deduct these expenses since they were not incurred in the pursuit of the business of the employer, the railroad; insofar as the employer's interests were concerned, the taxpayer could just as well have lived in Alabama and avoided the extra expense; the expenses were personal to the taxpayer since they were incurred only because he preferred to maintain a Mississippi residence. The Supreme Court avoided answering the questions—where is the taxpayer's "home" and when is he away from it—by holding that the expenses were not incurred in pursuit of the employer's business.

Prior to the *Flowers* decision the Tax Court had taken

* Commissioner v. Flowers, 326 U.S. 465 (1946).

the position, in cases with similar facts, that the taxpayer's "home" was his place of business (*i.e.*, Alabama, in the *Flowers* case); several of the Circuit Courts had taken the contrary position that "home" should be understood in its ordinary meaning as the place of the taxpayer's residence (*i.e.*, Mississippi, in the *Flowers* case).

Sec. 23(a)(1)(A) also specifies that rent is a deductible business expense if it is a payment for the use of property to which the taxpayer is not taking title. If the lease contains an option to purchase with the rents to be applied against the purchase price, the payments may be considered as part payments of the purchase price and not allowed as deductible expenses until such time as the lessee decides not to exercise the option.

Sec. 23(a)(1)(B) (Corporate Charitable Contributions) provides that a contribution by a corporation of a type that would be deductible under Sec. 23(q) (charitable, etc., contributions) cannot be deducted under Sec. 23(a)(1)(A) as a business expense. Sec. 23(q) limits a corporation's charitable deduction to 5% of the corporation's net income (before the charitable contribution deduction itself). Contributions to some organizations not within the charitable group, such as trade associations and chambers of commerce, are deductible as business expenses if the corporation obtains a fairly direct benefit from the contribution. But this section provides that strictly charitable contributions cannot be deducted as business expenses since the result would be to nullify the 5% limitation of Sec. 23(q).

The foregoing discussion of Sec. 23(a)(1) refers only to specific provisions that are included in the Code section itself. The section, however, begins with a statement that there shall be allowed as deductions "all the ordinary and necessary expenses paid or incurred * * * in carrying on

any trade or business". There are, of course, many expense deductions that are allowed besides those that have been discussed above. The Regulations under this section (Secs. 29.23(a)-1 to 29.23(a)-14) should be referred to for the provisions covering the deductibility of many other business expense items, such as insurance, advertising expenses, contributions to trade associations, etc., entertainment expenses, professional expenses, repairs, pensions to retired employees or their families, and payments as compensation for injuries. Certain of the later subsections of Sec. 23 also made specific provision for the deduction of particular items, such as interest, taxes, bad debts, etc., which are also business expenses, so that there is an overlapping of the provisions of those subsections and subsection 23(a)(1). These later sections are discussed in the order in which they appear in the Code.

Sec. 23(a)(2) (Non-trade or Non-business Expenses) has already been referred to as the section allowing the deduction of certain of those expenses. This section was added to the Code in 1942 to abrogate the rule of the *Higgins* case.* In that case, the taxpayer, who lived in France, maintained an office in New York in which several persons were employed in managing his real estate and security investments. The Supreme Court disallowed as a deduction all the expenses allocable to the management of the securities (amounting to about $16,000 a year) on the ground that those activities did not constitute a trade or business. That decision was rendered in 1941 and in 1942 the Congress enacted Sec. 23(a)(2).

Under Sec. 23(a)(2) expenses are deductible, even though not incurred in connection with a trade or business, if they are incurred in connection with (1) the production or collection of income or (2) the management, conservation or

* Higgins v. Commissioner, 312 U.S. 212 (1941).

maintenance of property held for the production of income. The basic distinction is between expenses that have some connection with income-producing activities or income-producing property and expenses that are purely personal. The latter expenses (excluding particular items such as interest and taxes which are allowed under later subsections of Sec. 23) are not deductible. For example, costs incurred in following an expensive hobby are not deductible under this or any other section.

When the Regulations under this section were first promulgated, the Commissioner took a very narrow view of the coverage of the section and ruled that many of the non-business expenses were still not deductible. But in 1945 the Supreme Court held, in the *Bingham* case,* that the section should be liberally interpreted to allow a taxpayer engaged in profit-activities or in the management of his productive property the same type of deductions that would be allowed if the activities constituted a trade or business. After that decision the Regulations were amended to reflect the new liberalized rule, and, at the present time, individuals are allowed to deduct non-trade or non-business expenses of approximately the same type that are allowable to taxpayers engaged in a trade or business. Those non-business expenses must, of course, meet all the requirements referred to above with respect to business expenses (except for the requirement of being incurred in a trade or business); that is, they must be "ordinary and necessary", "paid or incurred in the taxable year", and must be expense rather than capital items.

The Regulations (Sec. 29.23(a)-15) list many of the items that are deductible under this section and also certain items that are not deductible. A taxpayer not engaged in trade or business can, for example, now deduct under this section attorneys' or accountants' fees incurred for advice in the

* Trust u/w of Bingham v. Commissioner, 325 U.S. 365 (1945).

preparation of his income tax returns, or fees incurred in contesting a proposed income tax deficiency, or in litigating a claim for the refund of income tax. A taxpayer cannot, however, deduct under this section certain expenses that are considered personal in nature such as fees incurred for the drafting of his will, for the creation of a trust, or for advice on gifts and the preparation of gift tax returns.

Sec. 23(b) (Interest) provides for the deduction of all interest paid or accrued within the taxable year, with one exception. The exception is that interest on loans which are used to purchase or to continue to carry wholly tax-exempt obligations is not deductible.* This is an example of a general rule of tax law that expenses allocable to income which is itself exempt from tax cannot be deducted. The rule is entirely reasonable since if the deduction were allowed it would serve to offset other items of income which are intended to be taxed. Under this section, interest is deductible irrespective of whether the indebtedness is incurred in a trade or business or in connection with a profit-making activity; interest on purely personal indebtedness is deductible. It is important to note that interest on a federal or state income tax deficiency is deductible under this section; the allowance of this deduction reduces to a substantial extent the interest cost actually borne by the taxpayer.**

Interest paid by a corporation on its bonds is deductible under this section, whereas the dividends paid on its stock are not deductible. (Both the interest and the dividends are, of course, taxable income to the recipient.) This different treatment of interest and dividends makes it very important to determine whether a security is an equity or

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* There is one minor exception to this exception which is contained in the parenthetical clause of Sec. 23(b).

** On the other hand, interest received or accrued on an over-assessment is taxable income.

a debt security in the cases where a corporate security has certain of the features of both. The determination depends on the provisions of the particular instrument; a great deal of weight is given, however, to the questions whether there is a fixed maturity date and whether the amount is payable in any event or only if earned.

This different treatment of interest and dividends is the root of one of the present controversies over the double taxation of corporate distributions. Since dividends paid by a corporation are not deductible in determining its taxable income, there is, in effect, a double tax on a part of the corporate earnings. To assume an extreme example, suppose a corporation (with no debt securities outstanding) has income of $100,000; it pays a corporate tax of $38,000 on its entire income of $100,000; then, if it distributes to its stockholders the balance of the income after tax ($62,000), that amount is subject to tax in the hands of the stockholders. That amount of $62,000 has, therefore, been subjected to both the corporate and the individual tax. Assume, on the other hand, that a corporation with the same income of $100,000 has a large amount of bonds outstanding and pays out the entire $100,000 as interest; the corporation would then pay no corporate tax; the full amount of $100,000 would be taxed to the recipients but it would bear only the individual tax and not both the corporate and the individual tax. If the recipient paid tax in both cases at a rate of 50%, for example, the total tax on the $100,000 in the first case would be $69,000 while it would be only $50,000 in the second case. In an actual situation, of course, the comparison is not between a corporation that pays out all its income (after tax) as dividends and a corporation that pays out all its income as interest, since a corporation would ordinarily pay some interest and some dividends; but to the extent that a corporation pays dividends rather than interest there is a double tax on the corporation's earnings.

This preference that is now granted to debt financing as

compared to equity financing is accepted by almost all groups as an unfortunate result of the present taxing provisions, and many different proposals for its correction have been suggested. One proposal is to allow the corporation to deduct the dividends paid, just as interest payments are deducted, in determining the corporate net income subject to tax; another proposal is to allow the stockholders a credit against their tax for the corporate tax paid on the earnings distributed in the form of dividends.

Sec. 23(c) (Taxes) provides the general rule for the deduction of taxes in Sec. 23(c)(1). All taxes paid or accrued except those listed in Sec. 23(c)(1)(A)–(F) are deductible. Taxes are deductible, to the extent allowed, irrespective of whether they are incurred in connection with a trade or business or with the production of income—purely personal taxes are deductible. The main taxes that can *not* be deducted are federal income taxes, and both federal and state estate, inheritance and gift taxes. Income taxes paid to a foreign country or a possession of the United States can be deducted; those taxes can, however, in certain circumstances be taken as a credit against the tax, instead of as a deduction, under Sec. 131 (discussed in Chapter 8). In most cases it is advantageous to take a foreign tax as a credit against the United States tax when it is possible to do so, since it ordinarily results in a smaller aggregate tax liability. Federal excise and stamp taxes can *not* be deducted as taxes; however, if those taxes represent either business or non-business expenses, they can be deducted as expenses under Sec. 23(a). Also, taxes which are assessed against local benefits which tend to increase the value of the property assessed are not deductible. This exception refers to assessments for street, sidewalk, or other improvements which are levied against particular property and benefit that property; those items have to be treated as capital items and added to the cost of the property. Under Sec.

23(c)(3), retail sales taxes are deductible if the amount of the tax is separately stated and is paid by the purchaser.

As is the general rule for all deductions, a taxpayer can deduct a tax only if the liability for the tax is his and only if he is the one who pays the tax. As an example, a lease may provide that the lessee shall pay the real estate taxes on the property. The lessee can not deduct the amount paid, as taxes, since they are not his taxes; but he can deduct the taxes as an additional rental payment. The lessor takes the deduction for the taxes paid. If two persons own property as joint tenants or tenants by the entirety, each of them can deduct the taxes that he pays, even if one of them pays the full amount. (This same rule applies to payments of interest on a mortgage on property held in a joint tenancy or a tenancy by the entirety.)

The question of who is entitled to deduct taxes becomes very important when property is sold and the purchaser agrees to pay the taxes then outstanding against the property, or the vendor and purchaser agree to apportion the taxes according to the period of time before and after the date of sale. The purchaser will not be able to take any deduction for the taxes he pays if, in fact, they are not his taxes. The rule is that if the taxes were a lien on the property at the time of sale, or if the vendor was personally liable for the taxes at that time, only the vendor can take the deduction. In that case, the amount the purchaser pays as taxes is a part of his purchase price and has to be added to the capital cost of the property. The vendor takes the deduction for the taxes since, even though he did not pay them directly, they were paid by the purchaser for the vendor's account.

One other very important question that arises in connection with the deduction of taxes concerns the year in which a contested tax liability can be deducted. The general problem of the year in which deductions can be taken is discussed in Chapter 4 in connection with Sec. 43. The

particular problem of contested liabilities is, however, so closely related to the deduction of taxes that it is discussed here.

There is little difficulty with respect to a cash basis taxpayer since, whether or not he contests a tax liability, he takes the deduction in the year in which he makes the payment. The problem arises in the case of an accrual basis taxpayer who, for example, accrues a real property, state income, or other tax on his books, but does not pay it because he contests its validity. Even though he loses his contest, he cannot deduct the tax in the year in which he accrued it on his books: the Supreme Court held in the *Dixie Pine* case * that there is no proper accrual for tax purposes at a time when the taxpayer has not paid the tax and is contesting its validity; at that time the liability to pay is still contingent. The taxpayer is allowed the deduction in the year in which the contest is determined and his liability to pay becomes certain. If the taxpayer *pays* the tax (rather than just accruing it on his books) and then contests it and tries to obtain a refund, he can take the deduction in the year of payment even though he is on an accrual basis. Here, although the liability for the tax has not become certain in the earlier year, the fact of payment is sufficient to support the deduction.

Sec. 23(d) (Taxes of Shareholder Paid by Corporation) is not discussed.

Sec. 23(e) (Losses by Individuals) and Sec. 23(f) (Losses by Corporations) set out the losses that can be deducted by individuals and corporations. In the case of corporations, Sec. 23(f) allows the deduction of all losses sustained in the taxable year if they are not compensated for by insurance or otherwise; there are no other limitations in this section.

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* Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944).

In the case of individuals, however, only certain specified types of losses are allowed by Sec. 23(e); these must also be sustained in the taxable year and not compensated for by insurance or otherwise. The reason for the difference in the statutory provisions with respect to corporate losses and individual losses is that any loss sustained by a corporation is ordinarily a business loss while many losses sustained by individuals are personal and unrelated to any business or profit-making activity.

Individuals can deduct only the three following types of losses:

1) Losses incurred in trade or business.
2) Losses incurred in a transaction entered into for profit, even though the transaction does not constitute a trade or business.
3) Personal losses (*i.e.*, those not connected with a trade or business or with a transaction entered into for profit), *if* they arise from fire, storm, shipwreck, or other casualty, or from theft.

Losses of an individual which do not fit into any of the above three categories can not be deducted and the taxpayer gets no tax benefit from them.

Before getting any further into the subject of losses, one point should be emphasized. Although the foregoing types of losses of individuals and the losses of corporations can be deducted, some losses, called "ordinary losses", can be deducted from ordinary income, while other losses, called "capital losses", can be deducted only from capital gains.* The distinction between capital gains and losses and ordinary income and ordinary deductions, discussed in detail in Chapter 7, is extremely important and pervades many provisions of the Code; it is always necessary to keep in mind the differences in the tax treatment of the two types of

* There is a minor exception in that capital losses of an individual, to the extent of $1,000, can be deducted from ordinary income.

income and deductions. Capital gains are taxed at a maximum rate of 25% for both individuals and corporations. If a loss is, or is treated as, a capital loss it is allowed only as an offset against capital gains; net capital losses can be carried over for five years but only to offset capital gains in those years. Therefore, if there are no capital gains, the loss does not result in any tax benefit; if there are capital gains, it is only the 25% tax on those gains that can be eliminated. On the other hand, if a loss is an ordinary loss, it is deducted from gross income and offsets an equivalent amount of ordinary income which would otherwise be taxed at rates running as high as 38% for corporations and 82% for individuals. Because an ordinary loss produces a much greater tax benefit than a capital loss, it is important to determine in all cases whether or not a particular loss is an ordinary loss or has to be treated as a capital loss. The discussion in this chapter relates only to the question of what losses can be deducted; the further question whether a deductible loss is an ordinary loss or a capital loss is discussed in Chapter 7.

One other general point that should be kept in mind is that, despite the broad provisions of Secs. 23(e) and 23(f), there are certain losses that are not deductible, by either corporations or individuals, because of the specific provisions of some later section. The most important limitations are those contained in Sec. 24(b) (discussed later in this chapter) and in Sec. 112 (discussed in Chapter 5). Sec. 24(b) is mainly aimed at preventing tax avoidance and disallows certain losses because of the close relationship of the parties involved; Sec. 112 deals with certain exchanges of property in which neither gain nor loss is recognized.

Both Secs. 23(e) and 23(f) contain the two requirements that the loss must be sustained in the taxable year and must not be compensated for by insurance or otherwise. The requirement that a loss must be "sustained" means that there must be "a closed and completed transaction" or "an

identifiable event'' which fixes the loss. In other words, something must really happen during the taxable year to show that there was a loss and that it occurred in that year. For example, if a taxpayer owns stock that has gone down in value and he sells it at a loss, the sale would ordinarily show that the transaction in the stock was both closed and completed. If a building burns down, the fire is the identifiable event that fixes the loss. If property is stolen, the theft is the identifiable event. There must be a closed transaction or an identifiable event before either the taxpayer or the government can be sure that a loss exists.

Losses are sometimes allowed when a taxpayer abandons property; in that case, the act of abandonment is the event that fixes the loss. But, since abandonment depends somewhat on the taxpayer's state of mind and is not so tangible an event as the sale or destruction of property, the taxpayer must present clear proof that the property was worthless, that he intended to abandon it, and that he did actually abandon and cease to use it.

In the case of stock that becomes worthless it is often extremely difficult to point to a particular identifiable event that shows that worthlessness occurred in a particular year rather than in an earlier or a later year. The taxpayer cannot take the deduction in too early a year since the securities might then still have some, though little, value; and he cannot be what the courts call an ''incorrigible optimist'' and fail to take his loss until years have passed since the time the securities really became worthless. An identifiable event that shows the worthlessness may be the bankruptcy of the corporation, its liquidation, the cessation of doing business, the appointment of a receiver, etc. But worthlessness may have occurred prior to any of those events; and in order to take the deduction in one particular year the taxpayer must show that the stock was not worthless at the beginning of that year and that it was worthless at the end of that year. Even if the taxpayer sells the stock

in a particular year for a nominal sum, he will not be allowed the deduction in that year if, in fact, the stock was actually worthless in an earlier year.

The other general requirement of Secs. 23(e) and 23(f) is that the loss must not be compensated for by insurance or otherwise. If the taxpayer receives full compensation for his loss, there is of course no loss. If part of the loss is compensated for, only the balance, or the net loss, is deductible. If in the year of the loss the taxpayer has no reasonable expectation of recovering damages from a third person, or if although the property was insured the insurance company seriously contests its liability, the loss is ordinarily deductible. If the taxpayer then recovers compensation for his loss in a later year, the amount recovered (subject to the tax benefit rule discussed in Chapter 2) must be included in income in the year of recovery.

The types of losses allowed corporations do not need any particular discussion since Sec. 23(f) does not contain any limitations with respect to the nature of the losses allowed corporations. Under the first two subsections of Sec. 23(e), individuals are allowed to deduct losses incurred in a trade or business and losses incurred in any transaction entered into for profit. The term "trade or business" has the same meaning in this section that it has in Sec. 23(a), dealing with expenses incurred in a trade or business. The question whether the transaction in which the loss was incurred was one entered into for profit is a question of fact. A good illustration of the factual gradations that can be presented is provided by a loss sustained on the sale of a house. If the taxpayer bought and used the house for his personal residence, neither the purchase nor the use was for profit and the loss is not deductible.* On the other hand, if the

* If the taxpayer sells his residence at a gain, the gain is taxed since the requirement that the transaction must be entered into for profit refers only to losses and not to gains.

house was bought to rent to others, the loss is allowed; in that case, the taxpayer is either in the real estate business or is engaged in a transaction entered into for profit, and the loss comes within either Sec. 23(e)(1) or Sec. 23(e)(2). The intermediate case—a house purchased and used as a residence but later rented to others for a period before being sold—has now been settled in favor of the taxpayer; but the Bureau has successfully denied a loss where the taxpayer tried to rent his residence before sale but was unsuccessful. In this last situation, the courts hold that the loss is not allowable since the taxpayer is not engaged in a transaction entered into for profit until he has completely appropriated his house to income-producing purposes; and the taxpayer has not made such an appropriation if he has never actually rented the house.

The third type of losses allowed to individuals is that under Sec. 23(e)(3)—losses from fire, storm, shipwreck, or other casualty, or from theft. These losses, like other losses, can be deducted only in the year the loss is sustained. This rule creates no particular difficulty with respect to losses arising from fire, storm or shipwreck. However, with respect to losses resulting from theft or embezzlement, the rule requires the loss to be deducted in the year of the theft or embezzlement even though the taxpayer may not learn the facts until some years later. With a few exceptions, this rule has been adhered to in spite of the fact that, since a taxpayer may not discover his loss until several years after its occurrence, he may lose his right to deduct it. The term "other casualty" has been interpreted, for the most part, as including only events similar to fire, storm and shipwreck and as being limited to events arising from sudden and unusual causes. Thus, damage caused by an earthquake, by sudden freezes and by blasting have been allowed; while losses resulting from gradual deterioration of property have not been allowed because the loss was not sudden. One rather common loss that is allowed under this

section is the loss caused by damage to an automoble maintained purely for pleasure rather than for business use; the loss is allowed irrespective of whether the damage was caused by the faulty operation of the taxpayer's car or a third person's car, so long as it was not caused by a wilful act on the part of the taxpayer.

If a loss sustained by an individual taxpayer does not come within any of the provisions of Sec. 23(e), it is not deductible since this is the only section providing for the deduction of individual losses. It should be kept in mind that, when there is a question with respect to an individual loss, it must first be determined whether the loss is deductible at all under the provisions of Sec. 23(e). If the loss is deductible, it must then be determined whether the loss is an ordinary loss or a capital loss under the provisions of Sec. 117. If the loss is *not* deductible under Sec. 23(e), it is never deductible under Sec. 117 since the latter section does not provide for the deductibility of losses but merely sets out the rules for determining whether a deductible loss is an ordinary loss or a capital loss.

There are far too many kinds of losses for them to be discussed or even listed here. The Regulations contain some provisions with respect to particular types of losses and there are innumerable cases dealing with losses resulting from particular transactions. A mere shrinkage in the value of property does not, of course, create a deductible loss. No loss is "realized" when there is a mere shrinkage in value any more than a gain is realized from a mere appreciation in value. Further, to be deductible, a loss must be a loss of capital and not just a loss of expected income. If, for example, a taxpayer purchases goods expecting to sell them at a profit, but, because of a shift in the market, has to sell them at a price which reflects no profit, the expected profit is not a deductible loss. The potential profit has failed to materialize but the taxpayer is not actually out of pocket to any extent (assuming that he did not sell

at a price which not only reflected no profit but resulted in an actual money loss). If, however, a taxpayer on the accrual basis has *reported* an item as income which later fails to materialize, he can take a deduction for the loss; since the item has been subject to tax it is treated for tax purposes as part of his capital.

When a loss is allowed under the provisions of either Sec. 23(e) or Sec. 23(f), the general rule is that the amount of the loss is determined by reference to the adjusted basis of the property under Sec. 113(b); this is provided by Sec. 23(i). There is an exception, however, in the case of individual losses of non-business property resulting from theft or casualty, etc., under Sec. 23(e)(3). In those cases, the loss is measured by the difference between the fair market value of the property immediately before the casualty and the fair market value immediately thereafter, except that the loss cannot exceed the adjusted basis. For example, a pleasure car might have a cost of $1,800 and a fair market value of $500 just prior to an accident; after the accident, its fair market value might be $40; the allowable loss would be $460.

Sec. 23(g) (Capital Losses) contains two important limitations on the deduction of losses. The first is contained in Sec. 23(g)(1) which states that losses from the sale or exchange of capital assets shall be allowed only to the extent provided in Sec. 117; this whole question of capital losses is discussed in Chapter 7.

The second limitation is contained in Secs. 23(g)(2) and 23(g)(3) which provide that, if any securities that are capital assets become worthless during a taxable year, the loss shall be considered as a loss from the sale or exchange of capital assets, and as though the sale or exchange took place on the last day of the taxable year. This provision covers worthless stock and stock rights; there is a similar provision in Sec. 23(k)—the bad debt section—covering bonds and

notes that become worthless. The difficulty of determining the right year in which securities become worthless has been referred to above. That problem has been mitigated somewhat by an amendment to the Code * to provide a seven year statute of limitations (instead of the usual three year period) with respect to both worthless securities and bad debts. If, for example, a taxpayer claims a loss from worthless securities in 1948 and it is disallowed on the ground that the securities became worthless in an earlier year, he can still claim the loss in the earlier year by filing a claim for refund; under the present statute he can file such a claim for any previous year if seven years (rather than only three years) have not elapsed since the return for that year was filed.

Sec. 23(h) (Wagering Losses) merely provides that gambling losses shall be allowed only to the extent of gambling gains, that is, if the losses exceed the gains, the excess cannot be taken as a deduction. (When the gains exceed the losses, the excess is taxable income.)

Sec. 23(i) (Basis for Determining Loss) states that the basis for determining the amount of a deductible loss or bad debt is the adjusted basis for determining loss under Sec. 113(b); this latter section is discussed in Chapter 6. **Sec. 23(j) (Loss on Wash Sales of Stock or Securities)** is merely a cross-reference section.

Sec. 23(k) (Bad Debts) provides the rules for the deduction of bad debts. As a matter of definition, there can never be a bad debt deduction unless there is first a legal debt, that is, an amount owing to the taxpayer with respect to which there is a real and unconditional obligation of payment. If, for example, a father lends his son money to go into busi-

* Sec. 322(b)(5), discussed in Chapter 10.

ness, expecting repayment only if the business is successful, there is not a sufficient debtor-creditor relationship to support a bad debt deduction. In that case and many others, the loan falls in an area somewhere between a true loan and a gift. Even where there is a legal debt, *i.e.*, an unconditional obligation to repay, there can still be no bad debt deduction unless at the time the loan was made the creditor, as a practical matter, could reasonably expect repayment. One important exception to this latter rule is the right of an indorser or guarantor or surety to deduct a payment which he is required to make upon the default of the primary debtor. His payment creates a debt running to him from the primary debtor; but that debt is in the ordinary case uncollectible from its inception. Nevertheless, since he was legally obligated to make the payment, he can take a bad debt deduction.

Items such as unpaid rent, unpaid salaries, etc., which become uncollectible cannot be deducted as bad debts unless the items have, in some earlier year, been included in income. This is comparable to the rule that losses are deductible only if they are losses of capital or losses of potential income which has previously been accrued and taxed. If an income item has never gone into net income there is no justification for taking it out, by the deduction route, in a later year.

The Code distinguishes three types of debts: (1) business debts; (2) non-business debts of an individual; and (3) debts evidenced by certain securities. With respect to all three classes of debts, it must appear that the debt is worthless and that it became worthless during the taxable year. (A deduction for partial worthlessness, discussed below, is also allowed, but only with respect to business debts.) The clearest way, of course, to determine that a debt is worthless and uncollectible is to sue the debtor, recover a judgment, and show ~~that~~ the judgment cannot be collected. But in many cases actual suit is not necessary. If the facts

are such that it is clear that legal action to enforce collection of a debt would result in an uncollectible judgment, the proof of those facts is sufficient to sustain the bad debt deduction. As is often true, the law does not require a taxpayer to go through the motions of a useless act. If a debt is secured by collateral, it must appear that the collateral as well as the debt has no value before the deduction can be taken. In cases where there is no personal liability and collection of the debt can be made only from the collateral, the debt becomes worthless for tax purposes at the time when the collateral loses all value. The problem of determining the year of worthlessness is the same problem that exists with respect to losses—and quite as difficult to answer in many instances. Also, as in the case of losses from equity securities that become worthless, there is a seven year instead of a three year statute of limitations for the filing of refund claims based on bad debt deductions, in recognition of the fact that the year of worthlessness is not easy to determine.

Business bad debts are deductible in full against ordinary income. There are two methods used in determining the amount of the bad debt deduction. One is called the specific debt method, under which the taxpayer deducts in each year the specific debts that become worthless in that year. The other is the reserve method under which the taxpayer carries a reserve in the amount which he (and the Government) considers sufficient to cover his bad debt losses. Under this method the taxpayer makes an addition to the reserve each year so that the reserve remains at a figure sufficient to cover expected bad debts; he deducts from income the amount added to the reserve each year and charges against the reserve the debts that become worthless. It should be noted here that in tax law the bad debt reserve is unique; other common reserves, such as reserves against contingencies, reserves for future expansion, etc., are not recognized for tax purposes.

Sec. 23(k)

A taxpayer can also take a deduction for partial worthlessness, but only in the case of business debts. If it is clear that a part of a business debt is uncollectible, that part can be deducted in the year in which it becomes worthless; and the balance deducted in a later year if it then appears that the balance of the debt is worthless. In the case of a deduction for partial worthlessness, however, the amount that is worthless must be charged off on the taxpayer's books before the deduction can be taken. (This requirement that a bad debt must be "charged off" used to apply to all bad debt deductions, but now applies only to the deduction for partial worthlessness.)

The law with respect to debts secured by a mortgage is, at the present time, unnecessarily complicated. Insofar as the mortgagee is concerned, there is a bad debt deduction if the mortgaged property is sold at foreclosure sale for less than the amount of the debt and the deficiency is uncollectible. If, however, the mortgagee himself bids in the property at the foreclosure sale, he may have not only a bad debt deduction but, in addition, a gain or loss if the value of the property is greater or less than the amount of the bid price. As a further complication, when a mortgagee bids in the property at the face amount of the debt plus accrued interest, he is held to have received taxable income in the amount of the interest. These questions of the bad debt deduction and the gain or loss of the mortgagee, together with the questions relating to the loss of the mortgagor, are discussed in Chapter 7, following the discussion of the provisions of Sec. 117 dealing with capital gains and losses.

In accordance with the general rule applicable to many other deductions, if a bad debt is deducted as worthless in one year and the amount owed on the debt is unexpectedly repaid in a later year, the "recovery" is income to the extent that the earlier deduction resulted in a tax benefit to the taxpayer. As was pointed out earlier, the effect of that general rule is to make the taxpayer whole; he is left in

the same position taxwise * that he would have been in if he had never taken a deduction for the bad debt.

The second type of debts mentioned above was non-business debts of an individual. As in the case of losses, all debts of a corporation are treated as business debts. The non-business bad debts of an individual are those not connected with a trade or business. In many cases these are the bad debts that result when a purely personal loan is made and not repaid. In other cases, a taxpayer may have made a loan connected with his business, then gone out of the business, and afterwards had the loan become uncollectible; this type of bad debt is also treated as a non-business bad debt since the *loss* (although not the *loan*) occurred when the taxpayer is not engaged in the trade or business. The non-business bad debts are deductible but they have to be treated as short-term capital losses so that the benefit of the deduction (as is true of all capital losses) is limited. When a debt is a non-business bad debt, the deduction can be taken only in the year in which the debt becomes totally worthless; no deduction for partial worthlessness is allowed.

It should be noted that the purely personal expenses, losses and bad debts of individuals are all treated differently in the tax law. (1) Personal *expenses* (except extraordinary medical expenses) are not deductible at all. (2) Personal *losses* are deductible if they fall within the catagory of losses from theft or from fire, storm or other casualty. When personal losses are allowed they may be taken as deductions from ordinary income or allowed only as capital losses, depending on the particular facts. (3) Personal *bad debts* are deductible but they are allowed only as short-term capital losses.

The third type of bad debt is the debt evidenced by a security. The statute provides, in Secs. 23(k)(2) and 23

* Except to the extent that the tax rates applicable to his income vary in the different years.

(k)(3), that if any "securities" (as defined) become worthless during the taxable year, *and* the securities are capital assets, the loss shall be treated as a capital loss; in determining whether the loss is a short-term or long-term capital loss the loss is treated as though it resulted from a sale of the securities on the last day of the taxable year. This provision applies to corporations as well as to individuals. "Securities" are defined as meaning bonds, debentures, notes, certificates, or other evidences of indebtedness issued by a *corporation* (or those issued by a government or political subdivision) either with interest coupons or in registered form. (It should be noticed that this section covers debt securities while Sec. 23(g), referring to losses, covers equity securities; the treatment of the loss if the securities become worthless is exactly the same under the two sections.)

The non-business bad debt section (Sec. 23(k)(4)) specifically excludes from its coverage any debt evidenced by a "security". Therefore, a debt unconnected with a taxpayer's business and evidenced by a security falls within the worthless security section and not within the non-business bad debt section. The basic difference between the two sections is this: the non-business bad debt is treated as a capital loss, but always as a *short-term* capital loss; the worthless security bad debt is also treated as a capital loss but it may be either a long-term or a short-term capital loss. A short-term capital loss provides a greater tax benefit (as explained in Chapter 7) than a long-term capital loss, so that a non-business bad debt may provide a somewhat greater tax benefit than a bad debt evidenced by a security.

Sec. 23(l) (Depreciation) allows a deduction for depreciation and obsolescence. The amount allowed is "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property that is either used in the taxpayer's trade or business or

held for the production of income. As has been pointed out earlier, amounts expended for capital items cannot be deducted as business or non-business expenses since the items acquired will last and be used by the taxpayer for a relatively long period. But if the asset is subject to depreciation (and is used in the trade or business or for the production of income) the cost, or other basis, of the asset can be deducted through depreciation deductions over the period representing the usefül life of the asset. The depreciation deduction is allowed because the intent of the tax law is to tax only income and not capital; during the time a depreciable asset is producing income it is gradually wearing out and will, at some time in the future, have to be replaced. The depreciation deduction allows the taxpayer to accumulate a reserve (out of income before tax) which, at the end of the asset's useful life, will be equal to the cost of the asset; that reserve can then be used to replace the worn-out asset.

Depreciation is allowed only with respect to property (1) used in the trade or business or (2) held for the production of income. Because of that limitation, a taxpayer cannot take a deduction for the depreciation of his personal residence, household furnishings, or an automobile used only for pleasure. If, however, a house is rented, a deduction can be taken for depreciation since the house is then property used in the trade or business of renting property.* If property such as a house or an automobile is used in part for business purposes and in part for personal purposes, the depreciation that is allocable to the business use can be deducted.

Depreciation is allowed only with respect to property that is considered to be depreciable, that is, property whose usefulness gradually becomes exhausted. Land is not depreciable since (at least theoretically) it does not become

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* See discussion in Chapter 7 at page 221.

exhausted or worn out; also, inventories and stock in trade are not considered depreciable. Most other tangible property is depreciable. Certain intangibles are also depreciable, *e.g.*, those whose life has a definitely limited duration such as patents, copyrights, and franchises. Other intangibles which do not have a limited life are not depreciable; examples are the cost of organizing a business, goodwill and trade names.

The depreciation deduction is intended to allow the taxpayer to recover, tax-free, the cost or other basis of a depreciable asset less any salvage value. The amount to be recovered is, therefore, the original cost or other basis of the asset, increased by the cost of any improvements or additions which are capitalized rather than taken as expense deductions and decreased by any losses chargeable to capital account; this amount should, technically, be reduced by any salvage value but in practice salvage value is often disregarded in determining the annual depreciation deductions.

The amount of the annual depreciation deduction may be computed in accordance with several different methods. By far the most common, however, is the "straight-line" method. Under that method, the taxpayer ordinarily deducts the cost of the property in equal annual installments during the life of the property. If, for example, a taxpayer purchases a depreciable asset at a cost of $10,000, and if the life of the asset is 20 years, he deducts depreciation at the rate of 5%, or $500, a year. The Regulations do not state the rule in that form but state that the deduction shall be limited to "such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis". In the example above, the unrecovered cost at the beginning of the first year would be $10,000 and the remaining useful life would be 20 years so that 1/20th of $10,000, or $500, would be deducted in the first year. At the beginning of the

second year, the unrecovered cost would be $9,500, and the remaining useful life 19 years, so that 1/19th of $9,500, or $500, would be deducted in that year.

In many cases, the computation of depreciation in accordance with the rule as stated in the Regulations results in the same depreciation deduction that is obtained by deducting, in the above example, 5% of the original cost each year. But the method of computation as it is stated in the Regulations is the only method that will result in the proper annual deduction if, for example, there have been additions to the basis of the asset, or if the useful life is re-estimated, or if excessive depreciation has been taken in any year. If, for instance, the taxpayer in the example above had deducted depreciation of $1,000 in the first year and the excessive deduction had not been disallowed, the unrecovered cost at the beginning of the second year would have been only $9,000; the proper depreciation in the second year would then be 1/19th of $9,000, or $474 rather than $500.

In determining the amount of the depreciation deduction, the main problem is, of course, that of determining the useful life of the asset. The Bureau has published a bulletin called "Bulletin F" which sets out for a great many different types of assets the number of years of life which the Bureau will ordinarily accept. These estimates of useful life do not represent the only years of life which the Bureau will accept since the useful life of any given asset depends on many different factors; nevertheless, the lives as published in Bulletin F are important guides to the rates the Bureau will allow. Bulletin F is reprinted in the Tax Services.

Other methods of computing depreciation besides the straight-line method are allowed in certain circumstances if such other method properly reflects the actual depreciation of the asset. One of the more important of these is the "declining balance" method. Under this method, a fixed percentage of the unrecovered cost of the asset is deducted

each year as depreciation. For example, if an asset cost $10,000 and the declining balance rate was 10%, the depreciation in the first year would be 10% of $10,000, or $1,000. In the second year the depreciation would be 10% of the unrecovered cost of $9,000, or $900; in the third year, it would be 10% of the unrecovered cost of $8,100, or $810. The result of this method is that larger depreciation deductions are taken in the early years and smaller deductions in the later years; in the later years, however, the repair costs will ordinarily be greater. Under this method the total amount deducted for depreciation and repair expenses is more nearly equal from year to year than under the straight-line method.*

Depreciation can be computed either on an item basis or on a composite basis. An item basis means that depreciation is computed separately with respect to each asset. When a composite basis is used, the taxpayer may apply an average rate of depreciation to all the assets to be depreciated or he may group assets of a like nature together and apply to each group an average rate for the assets in that group.

One very important rule with respect to depreciation stated in the Regulations (Sec. 29.23(l)–5) is that the taxpayer cannot take advantage in a later year of his failure to take any, or sufficient, depreciation in an earlier year. Assume, for example, that the cost of an asset is $10,000 and that the proper depreciation is 5% or $500 a year. In determining the unrecovered cost at the beginning of any year, the taxpayer must reduce the original cost by the proper amount of depreciation for each prior year, whether or not he actually deducted that amount of depreciation in his return. He cannot, for example, take depreciation of

* Under present rulings, the Bureau will not allow a declining balance rate that is greater than 1½ times the straight-line rate; this will not allow the recovery of the full cost during the estimated life.

$500 a year for 15 years; then take no depreciation deduction for the next five years (because they were loss years in which he did not need the depreciation deduction); and then claim at the end of the 20th year that he has an unrecovered cost of $2,500. Irrespective of whether he took the depreciation deduction each year, and of whether the deduction gave him any tax benefit, his unrecovered cost, in this example, would be zero at the end of the 20th year. Moreover, if the taxpayer deducted in any one year a greater amount of depreciation, *e.g.,* $800, and if the deduction was not disallowed, the full amount of $800 would have to be taken into account in determining the unrecovered cost of the asset. Again, it does not matter whether or not the deduction of the excessive amount of depreciation resulted in any tax benefit.

The foregoing rule is expressed in a somewhat different form in Sec. 113(b) (discussed in Chapter 6) which provides that the basis of an asset shall be adjusted for depreciation "to the extent allowed (but not less than the amount allowable)". The "amount allowable" in the preceding example would be $500; and the "amount allowed" would be the $800 actually taken as a deduction in a particular return and not disallowed. These rules are not as arbitrary as they may at first sound. They rest on the general principles that for tax purposes there is an annual accounting period and that the income and deductions of that period must be reflected in the return for that period. A taxpayer cannot choose at will the year in which he will report income or take deductions. If he were allowed to pick the year in which he would take deductions, for depreciation or any other item, he would of course always take them in the years in which they would produce the greatest tax benefit.

The Code also provides that when property is held for one person for life, remainder to another, the deduction shall be allowed to the life tenant as though he were the absolute owner. When property is held in trust, the deduction is

Sec. 23(l)

taken by either the income beneficiary or the trustee, in accordance with the terms of the trust instrument; if the trust instrument does not contain any specific provisions, the deduction is allowed, as between the trustee and the income beneficiary, on the basis of the allocation of the trust-income.

This section of the Code also provides for the deduction of a reasonable allowance for obsolescence. Obsolescence occurs when there are changes in the arts, in methods of manufacture, in economic conditions or in legislation, etc., which result in shortening the normal useful life of property. Obsolescence usually means a loss of economic usefulness from abnormal causes rather than from ordinary physical wear and tear of the property. When a taxpayer can predict with reasonable certainty that certain assets will become obsolete at some fairly definite time in the future, he is allowed a deduction for obsolescence in addition to the depreciation deduction. The deduction for obsolescence is spread over the period between the time the process of obsolescence sets in and the date the asset becomes obsolete.

Sec. 23(m) (Depletion) provides for the deduction of depletion in the case of mines, oil and gas wells, other natural deposits and timber. This section is not discussed at any length since it is of only specialized interest. The purpose of the depletion deduction is to allow the owner of a depletable asset to recover his capital tax-free, and to tax him only on income. When, for example, ore is taken out of a mine and sold, the mine is being depleted, and a part of the proceeds from the sale of the ore represent a return of capital rather than income. It is necessary, therefore, to allow the mine owner some deduction so that when all of the ore has been mined he will have recovered his capital tax-free. Under the present very liberal provisions of this section, the owner in many cases is able to recover, tax-free, far more than his capital investment.

Sec. 23(n) (Basis for Depreciation and Depletion) is a cross-reference section, referring to Sec. 114; the latter section is discussed in Chapter 6.

Sec. 23(o) (Charitable and Other Contributions) and Sec. 23(q) (Charitable and Other Contributions by Corporations) cover the deduction for contributions to charitable, religious, educational and other organizations. Sec. 23(o) provides for the deduction in the case of individuals, and Sec. 23(q) provides for the deduction in the case of corporations. These deductions are fairly familiar to most people and do not need any extended discussion. The individual's deductions are limited to 15% of adjusted gross income, and the corporation's to 5% of net income computed prior to the deduction of the charitable, etc., contributions. The deduction is allowed only in the year in which the contribution is paid, regardless of whether the taxpayer is on a cash or accrual basis. One important point to note is that, when a contribution is made in property rather than in cash, the amount of the gift, and the amount of the deduction, is the fair market value of the property. Therefore, if a taxpayer makes a charitable contribution of property that has appreciated in value, he can take a deduction for the full amount of its fair market value (assuming it is within the 15% or 5% limitation); he is never taxed on the appreciation in value. The theory is that gain is not "realized" by a taxpayer when he gives property away.

Sec. 23(p) (Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan) sets out the very complicated rules covering the deduction of employers' contributions to pension and profit-sharing trusts and plans. This section has to be read and studied together with Sec. 165 since the latter section provides the rules for determining whether an employees' pension or profit-sharing plan qualifies as a tax-

exempt plan. Both sections are extremely technical and specialized parts of the law and are not discussed in any detail in this book. The general purpose and intent of the two sections is pointed out briefly in Chapter 8.

Sec. 23(r) (Dividends Paid by Banking Corporations) is merely a cross-reference section.

Sec. 23(s) (Net Operating Loss Deduction) provides for the allowance of a net operating loss deduction. The amount of this deduction is, however, determined under the provisions of Sec. 122 and the deduction is therefore discussed in Chapter 7 in connection with Sec. 122.

Sec. 23(t) (Amortization Deduction) is merely a cross-reference section.

Sec. 23(u) (Alimony, Etc., Payments) has already been referred to, in connection with the discussion of Sec. 22(k), as the section which provides that alimony payments made by a husband which are includible in the gross income of the wife are deductible by the husband. Sec. 23(u) refers only to payments made directly by the husband without the interposition of a trust. When a husband creates an alimony trust, the income from the trust is, under Sec. 22(k) and Sec. 171, not included in the husband's gross income; since he does not report the trust income, he is not entitled under Sec. 23(u) to a deduction for the payments.

Sec. 23(v) (Bond Premium Deduction) and Sec. 23(w) (Deductions of Estate, Etc., on Account of Decedent's Deductions) are merely cross-reference sections.

Sec. 23(x) (Medical, Dental, Etc., Expenses) provides for the deduction of extraordinary medical expenses. Only the expenses in excess of 5% of the taxpayer's adjusted

gross income are deductible, and the amount of the deduction is subject to two further limitations. The first limitation is that the deduction cannot exceed $1,250 times the number of exemptions to which the taxpayer is entitled under Section 25(b) (exclusive of the special exemptions for old age and blindness). The second limitation is that the deduction can in no event exceed $2,500 unless the taxpayer is married and files a joint return, in which case it cannot exceed $5,000. The deductible expenses include expenses for the medical care of the taxpayer, or his spouse, or any dependents of the taxpayer as defined in Sec. 25(b)(3) (discussed in Chapter 4). The deduction can be taken, however, only by the person who pays the expenses; and only for the year in which the payment is made, irrespective of whether the taxpayer reports on a cash or an accrual basis.

There is a further limitation in that the deduction can be taken only if the expenses are not compensated for by insurance or otherwise in the taxable year. If the deduction is taken in one year, and compensation is received in a later year, the compensation must be included in income in the later year to the extent of the deduction taken in the earlier year which resulted in a tax benefit. Assume, for example, that a taxpayer had medical expenses in 1947 of $1,500 and was allowed a deduction of $500; if he should recover $800 as compensation in 1948 he would normally have to include $500 of the recovery in income in 1948. This is in accordance with the general rule relating to recoveries, discussed in Chapter 2. In accordance with that general rule, the recovery is included in income only if, and to the extent that, the deduction in the earlier year resulted in a tax benefit to the taxpayer. The Regulations under this section set forth in considerable detail the types of expenses that are included within the term "medical care", and the method of computing the allowable medical expense deduction and the amount of any recovery to be included in income.

Sec. 23(z) (Amounts Representing Taxes and Interest Paid to Cooperative Apartment Corporation) provides for the deduction of certain amounts paid by a tenant-stockholder to a cooperative apartment corporation which represent the tenant-stockholder's proportionate share of interest and taxes. This section is not discussed.

Sec. 23(aa) (Optional Standard Deduction for Individuals) allows individuals, at their option, to take a standard deduction of a fixed amount instead of itemizing their deductions. If adjusted gross income is $5,000 or more, the standard deduction is $1,000 or 10% of adjusted gross income, whichever is less. There is an important exception to this rule: in the case of a married person filing a separate return the standard deduction is limited to $500. The effect of this exception is to limit the aggregate standard deduction of a married couple to $1,000 regardless of whether they file joint or separate returns. If adjusted gross income is less than $5,000, the standard deduction is approximately 10% of adjusted gross income but is allowed only if the taxpayer computes his tax according to the tax table (Supplement T). The Supplement T tax table automatically gives the taxpayer the benefit of the standard deduction. The standard deduction is in lieu of all deductions *except* those that are allowed under Sec. 22(n) in determining adjusted gross income; and in lieu of the credits specified in Sec. 23(aa), such as the credit for partially tax-exempt interest and the credit for foreign taxes. When a husband and wife file separate returns, one of them cannot take the standard deduction unless both do. The reason for this rule is fairly obvious since otherwise the husband could pay, and claim as itemized deductions, all possible deductible items of the couple and the wife could then claim the standard deduction in addition.

The Regulations list certain classes of taxpayers who are not allowed to take the standard deduction and certain

classes of returns in which the standard deduction is not allowed. For example, non-resident aliens cannot take the standard deduction; and the standard deduction is not allowed when a return is filed for a fractional part of a year because of a change in the taxpayer's accounting period. The Code section and the Regulations provide how the election is to be made and further state that the election to take the standard deduction shall be binding once made.

Sec. 23(aa), just discussed, is the last of the sections dealing with items that can be deducted. The foregoing discussion of Sec. 23 has dealt mainly with the types of items that can be deducted. The further question of the year in which the deduction should be taken is discussed in Chapter 4 in connection with Sec. 43.

Sec. 24 (Items not Deductible) contains important provisions as to items that can *not* be deducted from gross income in determining net income. Sec. 24(a) lists seven specific types of items that can not be deducted. Sec. 24(b) provides that certain losses from sales or exchanges of property shall not be allowed; these losses are disallowed, not because of the *type* of loss involved, but because of the close relationship of the parties to the sale or exchange. Sec. 24(c) provides that, in certain circumstances, expenses and interest cannot be deducted if they are not actually paid during the taxable year.

General Rule. Sec. 24(a) provides that no deduction shall be allowed in respect of seven specified types of items. The several provisions are discussed in the following paragraphs, numbered to correspond with the subsection numbers of that section.

(1) This section merely makes explicit the general rule that personal expenses, except extraordinary medical ex-

penses, cannot be deducted. The Regulations refer to many types of expenses and state whether or not they are considered as personal expenses. Interest and taxes can, of course, be deducted even though they are purely personal items; those items are, however, not treated in the Code as falling within the category of "expenses".

(2) and (3) These sections set out rules that have been discussed earlier—that amounts paid out for new buildings or for permanent improvements or in restoring or replacing property cannot be deducted. These are capital expenditures rather than expense items.

(4) This section provides that when a taxpayer pays the premiums on life insurance covering the life of an officer or employee, or of any person with a financial interest in the business, and the *taxpayer* is the beneficiary under the policy, it cannot deduct the premiums paid. A typical situation is where a company carries insurance on the life of an officer, payable to the company, in order to protect it against loss on the officer's death. The premiums paid are not deductible; but, on the other hand, when the proceeds of the policy are received by the company, they do not have to be included in income. If, however, the policy is payable to the officer's estate or to his beneficiaries (and is, therefore, not carried for the benefit of the company), any premiums paid by the company are ordinarily deductible as additional compensation paid to the employee; the premiums paid are then taxable income to the employee.

(5) This section provides that amounts which would otherwise be deductible cannot be deducted if they are allocable to a class of income wholly exempt from tax. Since the income items are entirely excluded from gross income, it is not necessary to permit any deduction to achieve an equitable result. There is one minor exception to this rule; expenses allocable to wholly tax-exempt interest are deductible if they are trade or business expenses.

(6) This section disallows the deduction of interest on money borrowed to purchase a single premium life insurance

or endowment contract; for the purpose of this section, any policy under which the premiums are fully paid within the first four years is treated as a single premium policy. This provision is similar to that in Sec. 23(b), disallowing the deduction of interest paid on money borrowed to purchase tax-exempt securities, and to that in subsection (5) just above, disallowing expenses allocable to tax-exempt income. The proceeds of the life insurance policy (if paid at death) will not be subject to income tax, and the taxpayer is therefore not permitted to reduce other, taxable income by interest paid on amounts borrowed to purchase the policy.

(7) This section deals with certain expense items which at the option of the taxpayer may be capitalized rather than deducted as expenses. This section merely states that if the taxpayer does elect to capitalize these items he cannot also take them as deductions. The Regulations (Sec. 29.24-5) permit a taxpayer to capitalize three main classes of deductible expenses.

a) With respect to *unimproved* and *unproductive* real property, the taxpayer may capitalize taxes, interest and other annual carrying charges.

b) With respect to real property in general (whether or not unimproved and unproductive), the taxpayer may capitalize certain classes of interest and taxes and other expenses (set out in the Regulations) paid or incurred in connection with the development of the property or the construction of improvements.

c) With respect to personal property, the taxpayer may capitalize certain classes of interest and taxes (set out in the Regulations) paid or incurred in connection with the purchase, transportation and installation of machinery or other fixed assets.

The second and third provisions above represent an acceptance by the Treasury of a general accounting principle that items of this nature are properly a part of the cost of property and should be capitalized rather than deducted

as expenses. It is important to notice that this section only allows a taxpayer to capitalize items which he could otherwise deduct as expenses; it does *not* allow him to take as expense deductions items which must be capitalized.

Losses from Sales or Exchanges of Property. Sec. 24(b) provides that losses on the sale or exchange of property cannot be deducted if the sale or exchange is made directly or indirectly between persons bearing certain specified close relationships to each other. The section applies irrespective of any question as to the bona fides of the sale. This section is intended to prevent taxpayers from taking tax losses through sales of property to members of their families or to controlled corporations. For example, a taxpayer might own securities that had gone down in value; he might want to take a tax loss in order to offset realized capital gains but might not want to give up all control over the securities. Except for the rules that are now contained in this section,* he could sell the stock to his wife or to his wholly-owned corporation and secure a tax loss without having parted, in any real sense, with the stock. Under this section, losses on *any* sales between persons of the relationships specified in the statute cannot be deducted. The section does not, of course, apply to gains.

Subsections (A) to (F) of Sec. 24(b)(1) state the relationships within which losses will not be allowed. Very generally, these are: members of a "family"; a corporation and its controlling stockholder; two corporations controlled by the same individual, if one of the corporations is a personal holding company **; a grantor and a trustee of a trust; the trustees of two trusts that have a common

* The provisions of this section are, to some extent, a statutory enactment of pre-existing case law. It had been held, prior to the enactment of the statutory provisions, that a taxpayer could not deduct losses on the sale of securities to his wholly-owned corporation.

** Personal holding companies are discussed in Chapter 11.

grantor; a trustee of a trust and a beneficiary of a trust. The section does not, however, apply to distributions in liquidation of a corporation; losses realized upon the liquidation of a corporation are allowed even though the distributions are received by a controlling stockholder.

It should be emphasized that this section is applicable quite regardless of the bona fides of the particular sale; the section applies to all sales between parties of the specified relationships. This section is in addition to the general requirement that a sale must be complete and bona fide to give rise to a deductible loss. When a sale is lacking in good faith, no loss will be allowed regardless of the relation or lack of relation between the parties. For example, this section does not specifically disallow losses on sales between a corporation and its wholly-owned subsidiary. Nevertheless, losses on such sales have been disallowed by the courts where the facts of the particular case showed that the sale was lacking in bona fides.

This section also provides the rules for determining who shall be treated as the owner of shares of stock for the purpose of this section. For example, an individual is treated as owning all the stock owned by any members of his "family"; and stock owned by a corporation, partnership, estate or trust, is treated as owned proportionately by the stockholders, partners or beneficiaries. These stock ownership rules, as set out in the Code and the Regulations, are extremely complicated and should be examined with great care in connection with any problem arising under this section.

As mentioned above, this section applies only to losses and does not affect the taxability of gains on sales between closely related persons. Moreover, the courts have held that where, for example, a stockholder sells several blocks of stock to his controlled corporation, some at losses and some at gains, the gains are taxable in full and cannot be reduced by the losses. In effect, the transaction is treated as though

there were two separate sales, one resulting in a taxable gain and the other in a non-deductible loss.

One further question is the meaning of the phrase "directly or indirectly" as it is used in this section in connection with sales or exchanges. It is perfectly clear that if a husband sells stock to his wife no loss is deductible. But suppose a husband sells stock through a broker on the open market and that a day or two afterwards his wife buys shares of stock in the same company through a different broker. Is this an indirect sale by the husband to the wife? The Supreme Court has recently held in the *McWilliams* case [*] that this type of sale is an indirect sale between husband and wife, the loss on which is not deductible.

Unpaid Expenses and Interest. Sec. 24(c) is another provision intended to prevent tax avoidance. Under this section, expenses deductible under Sec. 23(a) and interest deductible under Sec. 23(b) can *not* be deducted if *all three* of the following conditions exist:

1) the expenses or interest are not actually *paid* in the taxable year or within two and one-half months after the end of the year;
2) the payor is on the accrual basis and the payee is on the cash basis;
3) the payor and the payee are closely related persons between whom losses would be disallowed under Sec 24(b), discussed just above.

Before this section was enacted, taxes could be, and were, avoided or postponed by the following practice: a corporation reporting on the accrual basis would deduct compensation accrued to an officer who was perhaps also a controlling stockholder, and thereby reduce the corporate tax; it would, however, not actually pay the compensation to the officer until years later; the officer, since he reported on the cash

[*] McWilliams v. Commissioner, 331 U.S. 694 (1947).

basis, would not have to pay tax on the income until the later year in which it was received. The parties could, by this practice, control the year in which the deduction would be taken by the corporation and the year in which the income would be reported by the individual; and in the current year there would be a deduction by one taxpayer which was not offset by income reported by the other taxpayer.

This section not only prevents the deduction in the year the payor accrues the item, if the three conditions of the section exist, but also results in a substantial penalty. The accrual basis taxpayer who is prevented by this section from taking a particular deduction in the year of accrual cannot ever take the deduction. Since he is on the accrual basis, the expenses and interest are deductible items only in the year of accrual, and the deduction would not be allowed in the later year of payment.

CHAPTER 4

SECTION 25 TO SECTION 109

Sec. 25 (Credits of Individual Against Net Income) states the credits that are allowed to individuals for the purpose of the normal tax only and for the purpose of both the normal tax and surtax. (Sec. 26, discussed below, states the credits that are allowed to corporations.) Credits against net income must be distinguished both from deductions and from credits against tax. Deductions are the items (contained in Sec. 23) which are subtracted from gross income in arriving at net income; when the phrase "net income"

is used in the Code, it is this net income that is meant. After net income is determined, there are other items, set forth in Secs. 25 and 26, which are allowed as *credits* against net income—in effect, these items are also deducted. There is a real reason, however, for calling these items "credits against net income" instead of including them with the deduction items, since only certain credits are allowed in connection with certain taxes. For example, the credit for partially tax-exempt interest is allowed, both to individuals and corporations, only for normal tax purposes, and not for surtax. By treating these items as credits against net income it is possible to distinguish which items are to be allowed for which taxes. These credits against net income must also be distinguished from amounts allowed as a credit against the *tax* itself, *e.g.*, the credit allowed by Sec. 131 for taxes paid to a foreign country. The credit against tax is deducted directly from the tax, rather than from net income, and therefore in most instances gives a greater tax benefit.

Many of the credits against net income can be understood from a reading of the Code sections and the Regulations and do not need any particular explanation. The credits allowed to individuals by Sec. 25 are:

1) The credit for interest on obligations of the United States or instrumentalities of the United States if the interest is included in gross income but is exempt from normal tax—allowed for purposes of the normal tax only. As pointed out in Chapter 2, interest on all obligations of the United States or its instrumentalities issued on or after March 1, 1941 is fully taxable.

2) The credit allowed as a personal exemption of the taxpayer, and the credit allowed under certain circumstances as a personal exemption for the spouse of the taxpayer—allowed for both normal tax and surtax.

3) The credit for dependents—allowed for both normal tax and surtax.

Most people have at some time had to make out their own income tax returns, or the tax returns of a friend, and have therefore some practical familiarity with the mechanics of personal exemptions and credits for dependents. These exemptions and credits were materially changed by the 1948 Act. The new provisions are summarized below. It is important to note that a spouse is *not* a dependent of the taxpayer.

The taxpayer's personal exemption is now \$600. There is an additional exemption of \$600 for a taxpayer 65 years of age or older and a similar additional exemption for a taxpayer who is blind within the definition of the statute (Sec. 25(b)(1)(C)).

If the taxpayer is married and files a separate rather than a joint return, he can claim an additional \$600 exemption for his spouse but only if such spouse has no gross income and is not the dependent of another taxpayer. This additional exemption is similarly increased to \$1,200 if the spouse is 65 years old or blind and to \$1,800 if both.

The taxpayer is also entitled to a credit of \$600 for each dependent if the taxpayer furnishes more than one-half of that person's support, and if that person has less than \$500 gross income and is within the dependent classification set out in Sec. 25(b)(3).

As noted above, if a taxpayer and his spouse file a joint return the credits to which they would together be entitled are reduced by half; but since the net income shown in the return is similarly reduced by half the net effect is the same as if the full credits were allowed against the full net income.

Sec. 26 (Credits of Corporations) states the credits allowed to corporations. It is organized differently than Sec.

25. Sec. 25 specifies the tax for the purpose of which each credit is allowed; this is a simple matter since individuals are subject to only two taxes—normal tax and surtax. In the case of corporations, however, there are many different kinds of taxes and the credits allowed for each type of corporate tax differ. Sec. 26, therefore, lists all the credits allowed and states that the credits listed are allowed to the extent provided in the various sections imposing the taxes. For each tax, it is necessary to refer to the section which imposes the tax in order to determine which of the credits listed in Sec. 26 are allowed. For example, Sec. 26(a) contains the credit for interest on obligations of the United States and instrumentalities of the United States. Under Sec. 13 it is provided that this credit is allowed for the normal tax; and under Sec. 15 it is provided that this credit is not allowed for the surtax. A study of the tax returns themselves is the simplest way of determining what credits are allowed for the different taxes.

The most important credits for the ordinary business corporation are:

(1) The credit for partially tax-exempt interest—allowed for normal tax but not for surtax (Sec. 26(a)).

(2) The credit for dividends received (Sec. 26(b)). Under this section, corporations are allowed (for both normal tax and surtax) a credit of 85% of the dividends received from domestic corporations that are themselves subject to tax.* The purpose of this provision is to eliminate (to the extent of 85% of the dividends) a double tax on intercorporate dividends. Assume, for example, that corporation A owns part of the stock of corporation B, and that the net income of both corporations is $50,000 or more. The income of corporation B will be subject to a corporate tax of 38% leaving a balance of 62%. If a part of the balance is dis-

* Subject to the limitation that the credit cannot be more than 85% of the corporation's adjusted net income.

tributed in the form of dividends to corporation A, the amount distributed becomes a part of the earnings and of the taxable income of corporation A. Except for this section, the dividends received by corporation A would again be subject to a tax of 38%. Because of the provisions of this section corporation A is taxable on only 15% of the dividends received from corporation B. The effective rate of tax on intercorporate dividends is, therefore, 38% of 15%, or 5.7%.

(3) The credit for a net operating loss (Sec. 26(c)). This section is particularly difficult to understand without some explanation. This net operating loss credit must not be confused with the net operating loss deduction provided in Secs. 122 and 23(s). The latter sections provide that if a corporation sustains an operating loss in any year it may carry that loss back for two years and forward for two years as a deduction from gross income. Sec. 26(c) provides a *credit* for the net operating loss of the preceding year only. The reason for this provision is that the Sec. 122 net operating loss deduction is *not* allowed with respect to the following taxes: (1) the penalty surtax under Sec. 102, imposed upon corporations improperly accumulating surplus; (2) the tax on foreign personal holding company income under Supplement P (Secs. 331–340); and (3) the surtax on personal holding companies under Subchapter A (Secs. 500–511). In determining the income subject to those three taxes, only the more limited net operating loss set out in Sec. 26(c) is allowed. Since this section is of no importance except in connection with the above three special taxes, it is not discussed further. The general net operating loss deduction which is allowed for the purposes of the corporate normal tax and surtax is discussed in Chapter 7 in connection with Sec. 122 which sets out the rules for the computation of the deduction.

(4) The dividends paid credit and the consent dividends

credit (Secs. 26(f) and 26(g)). These provisions are discussed below.

Sec. 27 (Corporation Dividends Paid Credit) and Sec. 28 (Consent Dividends Credit) are both extremely technical in their provisions. Neither of these sections is relevant to the computation of the corporation normal tax or surtax. With respect to the Code provisions discussed in this book, these sections are relevant only to the computation of the following three special taxes: (1) the Sec. 102 penalty surtax on corporations improperly accumulating surplus; (2) the surtax imposed under Subchapter A on personal holding companies generally; and (3) the tax imposed under Supplement P on foreign personal holding company income. The provisions of Secs. 27 and 28 are explained at this point in order to follow the organization of the Code, and also in order to avoid later confusion when the three special taxes are discussed. It is suggested, however, that any careful study of these sections be deferred until the sections of the text covering Sec. 102, Subchapter A and Supplement P are read, and that these sections be referred to at that time.*

All three of these special taxes are imposed only on the income of a corporation that is not "distributed". In order to exempt a part of the income from these taxes, certain credits are therefore allowed in determining the "undistributed income" subject to each special tax. In determining the income subject to the Sec. 102 surtax and the income subject to the foreign personal holding company tax, there is first deducted (with some minor exceptions) the "basic surtax credit"; in determining the income subject to the Subchapter A personal holding company surtax, there is first deducted (with some minor exceptions) the "dividends paid credit". Secs. 27 and 28 merely define those terms.

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* Sec. 102 is discussed later in this chapter; Subchapter A and Supplement P are discussed in Chapter 11.

The term "dividends paid credit" is defined in Sec. 27(a). The two important components of that credit are those in Sec. 27(a)(1) and Sec. 27(a)(2), that is, the basic surtax credit and the dividend carry-over. For the purposes of this book, Secs. 27(a)(3) and 27(a)(4) can be ignored since the provisions of those sections are not taken account of in the computation of any of the three special taxes considered here. For present purposes, then, the dividends paid credit can be thought of as meaning the sum of the "basic surtax credit" and the "dividend carry-over".

The basic surtax credit is defined in Sec. 27(b) as the sum of (1) the dividends paid during the year, (2) the consent dividends credit under Sec. 28 (explained below) and (3) the net operating loss credit under Sec. 26(c) (discussed above). The foregoing sum is reduced, however, by any credit that would otherwise be allowed for partially tax-exempt interest.*

The dividends paid during the year, which are a part of the basic surtax credit, are not in the usual case difficult to determine. It should be noted, however, that certain distributions, such as preferential dividends and non-taxable dividends, are excluded by the statute from the dividends paid credit. The net operating loss credit under Sec. 26(c) has already been referred to. The other item included in the basic surtax credit is the consent dividends credit. This credit is set out in great detail in Sec. 28, the provisions of which are far too technical for any detailed discussion here. The general idea of consent dividends is as follows. From the government's point of view, the Sec. 102 tax and the Subchapter A surtax on personal holding companies are imposed in order to force those corporations to distribute their income so that it becomes subject to tax in the stock-

* There is a further adjustment for a bank affiliate credit which is omitted from discussion.

holder's hands. If the stockholders are willing to pay tax on the income of the corporation, whether or not it is actually distributed to them, it makes little difference to the government whether there is an actual distribution or not. Therefore, the corporation is allowed, in determining its income subject to these taxes, to deduct in addition to amounts actually distributed any other amounts which the stockholders agree to report as income in their individual income tax returns. The phrase "consent dividends" means exactly what it says—that the stockholders consent to treat certain amounts as dividends. Because of the high rates of these surtaxes it is often, but not always,* to the advantage of the stockholders to treat amounts that have not been received as consent dividends, since the additional corporate tax is thereby avoided.

The other item included in the dividends paid credit (besides the "basic surtax credit") is the "dividend carry-over", computed under the provisions of Sec. 27(c). The dividend carry-over is allowed for the purposes of the Subchapter A surtax on personal holding companies; it is *not* allowed for the purposes of the Sec. 102 tax or the Supplement P tax on foreign personal holding company income. In determining the income subject to the latter taxes, only the basic surtax credit is allowed. The general meaning of the carry-over is not difficult; if a personal holding company pays out in one year more dividends that it needs to in order to escape the personal holding company surtax, it is allowed to carry over the excess to the next two years as a part of its dividends paid credit for those years. The rules for computing the exact amount of the dividend carry-over (contained in Sec. 27(c)) require, however, very careful study.

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* As explained later in this chapter, it is sometimes to the advantage of the stockholders to have the corporation pay the Sec. 102 penalty surtax rather than to have the earnings taxed to the stockholders.

Both Sec. 27 and Sec. 28 are complicated and technical sections but they do not need to be referred to at all in determining the normal tax and surtax liability of a corporation. They are relevant only to the Sec. 102 surtax and the personal holding company surtaxes.

Sec. 31 (Taxes of Foreign Countries and Possessions of United States), Sec. 32 (Taxes Withheld at Source) and Sec. 33 (Credit for Overpayments) are cross reference sections. **Sec. 35 (Credit for Tax Withheld on Wages)** merely provides that the tax withheld from the salary or wages of an individual shall be credited against his income tax liability.

Sec. 41 (Accounting Periods and Methods of Accounting—General Rule) together with Sec. 42 and Sec. 43, discussed below, sets out the rules as to the year in which a taxpayer must include items in income and the year in which he may take deductions.

Sec. 41 provides that a taxpayer shall compute his net income (1) on the basis of his annual accounting period and (2) in accordance with the method of accounting he uses in keeping his books. An annual accounting period is either the calendar year or a fiscal year. A fiscal year is any twelve-month period that ends on the last day of any month except December. There are two general methods of accounting—the cash basis and the accrual basis. Individuals, particularly those who are not operating a business, ordinarily report on the cash basis. Taxpayers who do not keep books have to report on the cash basis and on a calendar year basis. Corporations and individuals engaged in business are more likely to use the accrual basis; and, if the business is one in which inventories are necessary, the cash basis is not permitted.

Other methods of accounting besides the cash and accrual methods are permitted by the Code and Regulations, subject to the general rule that the method used must "clearly reflect the income". Among the methods that are sometimes used are the completed contract basis and the percentage of completion basis, both used in connection with long-term construction contracts; and the installment basis of reporting profits from installment sales. The installment basis is discussed later in this chapter.

Sec. 42 (Period in Which Items of Gross Income Included) and Sec. 43 (Period for Which Deductions and Credits Taken) refer respectively to income and deduction items. Sec. 42 provides, in effect, that a taxpayer on the cash basis shall include items in gross income in the year in which he receives them and that a taxpayer on the accrual basis shall include items in gross income in the year in which they accrue. Sec. 43 provides the correlative rules with respect to deductions—that a taxpayer on the cash basis shall deduct items in the year in which he actually pays them and that a taxpayer on the accrual basis shall deduct items in the year in which they accrue or are incurred. Since taxpayers must report both income and deduction items on the same basis, the rules under Secs. 42 and 43 are discussed together, first with respect to cash basis taxpayers and then with respect to accrual basis taxpayers.

Cash Basis. The question when items shall be reported does not create many problems for the cash basis taxpayer. The cash basis is essentially an in-and-out-of-pocket method of reporting and the taxpayer includes items in gross income in the year they are received and deducts items in the year they are paid. Items do not, of course, have to be received or paid in cash; receipts and payments in property are income or deduction items to the extent of the fair market

value of the property. It should be noted in this connection that a note received by a cash basis taxpayer is ordinarily income to the extent of its fair market value, which will usually be its discount value. (If, however, a cash basis taxpayer who holds a debtor's note receives an additional note covering accrued interest, the courts hold that he has not received interest at that time since the additional note gives him no rights he did not have before.) On the other hand, the mere giving of a note by a cash basis taxpayer is not treated as a payment and a deduction is allowed only when the note is paid.

On the income side, there is one doctrine of considerable importance for cash basis taxpayers which was referred to in Chapter 2—that of constructive receipt. Under this doctrine, if an income item is credited to the account of or set apart for a taxpayer and if he can obtain the amount at his own volition without any substantial conditions attached, the item must be included in his gross income even though it is not actually reduced to possession.* The Regulations give several examples of items that are treated as constructively received even though there has been no actual receipt. This doctrine operates to prevent taxpayers from determining at will the year in which they will report income; without this doctrine, taxpayers could allow income items to remain to their credit and could postpone taxability until such time as they chose to reduce the items to actual possession.

On the deduction side, the cash basis taxpayer is able, in a few situations, to control the year in which he will take deductions. He can, for example, prepay taxes and mortgage interest and take the full deduction in the year of payment, even though the expenses relate to future years.

* Even though the payee must include the item in income, that does not mean that the payor, if he is on the cash basis, obtains a deduction at that time; the payor can take the deduction only when actual payment is made.

This has been a fairly common practice in years when taxpayers expect tax rates to be reduced in the following year. The rules as to prepaid items vary, however, since, although prepaid taxes and interest can be deducted, it has been held that prepaid rent and insurance premiums can not be deducted in the year of payment but have to be spread over the period covered by the payment. These latter rules introduce a slight flavor of the accrual method into cash basis reporting.

Accrual Basis. The question of when items shall be reported raises so many problems for the accrual basis taxpayer that no attempt can be made here to treat them in any detail. The general rule is that taxpayers on the accrual basis report both income and deduction items in the year they accrue. Income items accrue at the time the taxpayer's right to receive them becomes fixed and certain; and deduction items accrue at the time the taxpayer's liability to pay becomes fixed and certain. There is an accrual when the right or the liability is certain even though the amount is not definitely determined, so long as the amount can be estimated with reasonable accuracy.

For example, if a lawyer on the accrual basis had completed his work on a particular job for a client by November in a certain year and the amount of his fee was agreed upon, he would include the fee in his income for that year irrespective of whether he received payment by the end of the year. If the same lawyer had an assistant to whom he paid a monthly salary and a bonus computed as a percentage of the annual earnings, the bonus not being paid until the following year, he would deduct as an expense of the taxable year not only the salary but also the bonus; although the bonus would not be paid until the following year, the liability to pay it would be fixed and certain and the amount determinable (*i.e.*, capable of a reasonably good estimate) in the taxable year.

Secs. 42, 43

On the income side, the accrual basis taxpayer reports income in the year in which his right to receive it is fixed and certain; if the income is uncertain of collection or contested, the right to receive it is not fixed and certain and the income is not accruable at that time. For example, an accrual basis taxpayer would ordinarily accrue interest receivable whether or not it was received during the year; but, if the financial condition of the debtor was such that eventual collection of the interest was very doubtful, the interest would be too contingent to be accrued. Or, if the debtor contested his liability for the interest, the amount would not be accruable until the contest was determined.

In the ordinary case, accrual precedes actual receipt since there is an accrual when there is a *right* to receive. But in some cases items are received before they are earned, and then the receipt precedes the accrual. For example, an accrual basis taxpayer might receive rental payments in advance or fees for services to be rendered in the future; with some exceptions, those amounts have to be reported in the year of receipt even though they are not yet earned.

Further, under the principle of the *North American Oil* case,* a taxpayer must report as income an amount received under a claim of right, and without restriction as to its disposition, even though he may have to return all or a part of it in a future year. This principle applies equally to cash and accrual basis taxpayers. In the *North American Oil* case, the ownership of certain oil lands was disputed between the taxpayer and the government; a receiver was appointed to operate the property during 1916; in 1917 a District Court dismissed the government's claim and turned over to the taxpayer the income that had been earned in 1916; the government appealed and the litigation was finally terminated in favor of the taxpayer in 1922. The Supreme Court held that the amounts received by the taxpayer in

* North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932).

1917 were income to it in that year, even though it was not certain in that year whether or not the amounts would have to be returned to the government at a later time. (If the taxpayer had lost the appeal and had had to return the amounts in a later year, it would have been entitled to a deduction in the later year.) The principle underlying this rule is that a taxpayer is taxable on income which is actually in his possession and which he can dispose of (at least for the time being) without restriction. Of course, if the taxpayer does not hold the amounts under a "claim of right" he is not taxable on them. For example, if a taxpayer sells goods in bottles or other containers and requires his customers to make a deposit on the containers, the deposits are not income since they are not held by the taxpayer under a claim of right but are held as amounts belonging to the customers.

On the deduction side, the accrual basis taxpayer deducts items in the year in which his obligation to pay becomes fixed and certain and the amount is determinable. For example, the accrual basis taxpayer would ordinarily deduct interest payable whether or not it was paid during the year; if, however, the taxpayer's financial condition was such that there was no reasonable expectation that the interest would ever be paid, the deduction would in most cases not be allowed. The rules as to contingent and contested liabilities are much the same as the rules with respect to contingent and contested income items. A taxpayer cannot deduct an item in a year when he is contesting his liability for it, since there is then no proper accrual; the deduction is not allowed until the year when the contest is settled and the liability finally determined.* Also, the taxpayer cannot deduct a liability that is merely contingent. There are many types of liabilities that are contingent and against

* If the taxpayer pays the amount during the course of the contest, he is allowed the deduction in the year of payment—see page 70.

which a business might carry a reserve on its books. But those liabilities or reserves for future estimated expenses or losses cannot be deducted since the liabilities are only contingent and not certain. As one example, if an action is brought against a taxpayer for damages, he has a contingent liability to pay a future judgment if the case is decided against him and he might set up a reserve against the liability; but until the judgment is handed down, the liability is purely contingent and cannot be accrued.

There are a few exceptions to the general rule that an accrual basis taxpayer deducts items in the year of accrual. Under particular statutory provisions, charitable contributions, extraordinary medical expenses and alimony payments can be deducted only in the year of payment, irrespective of whether the taxpayer is on a cash or an accrual basis.

As stated before, the accrual of income and deduction items raises numerous and complicated problems; it is not possible to include in this book the detailed rules with respect to each different item. Merely as an example of the type and complexity of the problems, the following resume of the rules for the deduction of taxes is given: assume that the tax referred to is an income tax imposed by State X which is deductible for federal tax purposes; the question is the proper year for a taxpayer on the accrual basis to deduct the tax.

1) The basic rule is that the taxpayer deducts the state income tax liability for, say, 1946 in his federal return for 1946 since in that year all the events have occurred to fix the fact and the amount of the liability, even though there may be no technical assessment until the following year.

2) If an uncontested deficiency is assessed with respect to the state income tax for 1946 and is paid in 1948, it can ordinarily not be deducted in the year of payment but can be taken only as a 1946 deduction

(by filing a federal refund claim). Again, the theory is that in 1946 all the facts existed for the determination of the correct state income tax liability for that year, so that the liability properly accrued in 1946.

3) Then suppose that in 1947 State X increases its income tax rates and makes the increase retroactive to 1946; and that the taxpayer pays the additional tax for 1946 in 1947. If the change was made after March 15, 1947, the due date for filing the 1946 federal return, the additional tax would be deductible in 1947, since one of the facts necessary to an accrual (the increase in rates) was not known or knowable when the federal return for 1946 was filed. If the change in rates occurred prior to the due date of the federal return, the additional tax would probably be allowed as a deduction only in 1946.

4) Then suppose that the taxpayer, in 1946, accrued his liability for the 1946 state income tax on his books, but did not pay it and contested his liability. In that case he could not deduct the tax in his 1946 federal return since an item cannot be accrued while liability is contested. That principle, stated in the *Dixie Pine* case, has already been referred to in Chapter 3 in connection with the deduction of taxes under Sec. 23(c). The taxpayer would be allowed the deduction in the year the contest was settled and his liability determined.

5) Then suppose that, in the example above, the taxpayer paid the 1946 state income tax in 1947, and thereafter contested his liability and attempted to recover the tax. In that case, he would be allowed the deduction in 1947 because of the payment made in that year, even though his liability for the tax was not then finally determined. This principle has also been referred to in Chapter 3 in connection with the deduction of taxes.

The question of the year in which items are included in income and the year in which deductions are taken is of great importance to many taxpayers. In a year when, for example, an individual taxpayer is in an unusually high surtax bracket, an additional item of income will be taxed at higher rates than it would be if it were includible in the gross income of a different year; on the other hand, a deduction item will result in a greater tax benefit if it can be taken in a high surtax bracket year. Not only the tax brackets of an individual (and to some extent of corporations) shift from year to year, but the tax rates themselves vary, resulting in a further difference in the tax burden on income and the tax benefit of deductions. A deduction allowable to a corporation, for example, in 1945 might offset income that would otherwise be taxed at an excess profits tax rate of 85½%; while if the deduction were allowable only in 1947 (after the repeal of the excess profits tax law) it would offset income that would otherwise be taxed at a top rate of only 38%. Also, a deduction might be of no tax benefit at all if it were allowable only in a loss year, since there would then be no taxable income to be offset.*

The problems of the right year for income and deductions all flow from the requirement that income is to be reported on the basis of annual periods. This concept is fundamental to the income tax law and unquestionably simplifies its administration. There are a few exceptions to it, such as the carry-over and carry-back of net operating losses allowed by Sec. 122, the carry-over of capital losses allowed by Sec. 117, and the limitation on the tax attributable to income earned over a period of years provided by Sec. 107. Those sections which are subsequently discussed represent attempts to mitigate some of the hardships that arise from the necessity of annual accounting periods.

* The deduction even though allowed only in a loss year might result in a tax benefit through the operation of the loss carry-back and carry-over provisions of Sec. 122, discussed in Chapter 7.

Sec. 44 (Installment Basis) sets out the rules for reporting income on the installment basis. The general effect of this method is that a taxpayer reports the profit from installment sales during the years in which he receives the profit. This method is optional with the taxpayer but can be used only with respect to the following types of sales:

1) Installment dealers—those regularly selling personal property on the installment plan—may report all income from installment sales on the installment basis.

2) Other taxpayers may report income from the following types of sales on the installment basis, provided that there is an initial payment (*i.e.*, received in the year of sale) and that it does not exceed 30% of the selling price:

   a) Casual sales of personal property if the selling price exceeds $1,000, and

   b) Sales of real property.

The installment basis of reporting income from sales may be used regardless of the method used in reporting the taxpayer's other income.

The section provides that if the taxpayer elects to use the installment method he may report as income that proportion of the installment payments received in each year which the gross profit bears to the "total contract price". The "total contract price" is the same as the selling price except where the purchaser assumes or takes subject to a mortgage. In those cases, the amount of the mortgage is not a part of the total contract price. The amount of the mortgage is also not a part of the "initial payments".* The operation of these provisions can be most easily understood through an example. Assume, for example, that mortgaged property with a basis of $6,000 is sold for a

* There is an exception when the amount of the mortgage exceeds the basis of the property sold, set out in the Regulations (Sec. 29.44-2).

selling price of $10,000; the buyer makes a down payment of $3,000, assumes a mortgage of $2,000 and agrees to pay the balance of $5,000 over the period of the next five years. The gross profit is, of course, $4,000; the total contract price is $8,000; the proportion of the gross profit to the total contract price is therefore 50%. The taxpayer reports as income in the first year 50% of the initial payment of $3,000, and reports in each of the next five years 50% of each $1,000 received. Over the entire period, he reports as income 50% of $8,000, or his entire profit of $4,000 on the sale.

It should be noted that, except for the special provisions of this section, the seller in the example above, even if he were on the cash basis, would have to treat as the proceeds of the sale in the year of sale not only the cash received and the mortgage assumed but also the fair market value of the buyer's deferred payment obligations. If the obligations were worth their face value, he would have to report the entire $4,000 as income in the year of sale.

When property is sold at a profit (and particularly in cases where the capital gain rate does not apply) a substantial tax saving can often be obtained by making the sale an installment sale and reporting the income on that basis, since the income is thereby spread over a period of years and taxed at lower surtax rates. In order to obtain the advantages of this section, however, a taxpayer must report the sale on the installment basis in his original return; if he fails to do so, he cannot later file an amended return using the installment basis.

It is important to notice that under this section sales of property by persons who are not installment dealers can be reported on the installment basis only if the initial payments do not exceed 30% of the selling price. Thus, in the example above, if the down payment were $4,000 rather than $3,000 the installment basis could not be used. One other limitation contained in the Regulations is that the installment basis can be used only if there is *some* initial

payment in the year of sale; if, for example, the sale is made in 1947 and the buyer agrees to make the payments over the period 1948 to 1950, no payment being made in 1947, the installment basis cannot be used.

The Regulations under this section (Sec. 29.44–4) also set forth the method of reporting income from a deferred payment sale of a type that cannot be reported on the installment basis because of the fact that the initial payments exceed 30% of the selling price. The term "deferred payment sale" implies that payment is to be made over a period of time, and the seller would ordinarily receive a down payment and the obligation of the purchaser, in some form, to pay the balance. In that case, the seller is deemed to have received in the year of sale the amount of cash received plus the fair market value of the purchaser's obligations. If, for example, the obligations were worth 70% of their face value, that amount would be deemed to be received in the year of sale.

Assume, for example, that property with a basis of $8,000 is sold and that the seller receives $4,000 in cash and the purchaser's obligations in the face amount of $10,000; assume further that at the time of their receipt the obligations are worth 70% of face value. The seller in that case would be deemed to have received in the year of sale $11,000 (the $4,000 received in cash and the obligations valued at $7,000). He would report $3,000 as profit in the year of sale (the excess of the amount received in that year over the basis of the property). As the obligations are paid in later years, the seller would treat 7/10ths of each payment as a return of his capital or basis, and 3/10ths of it as income. When the obligations are paid in full, the seller will have reported as income the full $6,000 profit.

The Regulations also contain very complicated rules, which are not discussed here, for ascertaining gain or loss if the purchaser, either under an installment sale or a deferred payment sale, defaults on his obligations and the property is repossessed by the seller.

Sec. 44(d) provides the rules for computing gain or loss if the installment obligations, instead of being held and collected upon by the seller, are given to another person, or sold, or otherwise disposed of. These very technical rules are not discussed. The effect of the provisions is that the installment profit which would otherwise be deferred is immediately realized and taxable in the year the obligations are disposed of. An exception to this rule * is provided in the case of the death of an individual owning installment obligations. Upon death, there is, of course, a transmission of the obligations to the executor or administrator or other distributee; and under the general rule of the Code the entire amount of profit not previously reported would be realized and taxable in the year ending with the decedent's death. To avoid that result, the Code provides that the income need not be reported in the last return of the decedent if a bond is filed in effect guaranteeing that the person who eventually receives the installment payments will report in his tax return the same proportion of each payment that would have been reported by the decedent had he lived.

Sec. 45 (Allocation of Income and Deductions) is an extremely important section since it gives to the Commissioner a far-reaching power to prevent certain types of tax avoidance. Under this section, if two or more organizations, trades or businesses are owned or controlled by the same interests, the Commissioner can reallocate gross income or deduction or credit items among the organizations, trades or businesses if such reallocation is necessary in order to prevent tax evasion or in order that the net income of each of the organizations shall be clearly reflected by its return. It does not matter under this section whether or not the

* Further exceptions are provided by the Code and Regulations in the case of distributions which come within the provisions of Sec. 112(b)(4), Sec. 112(b)(5) and Sec. 112(b)(6). These latter sections are discussed in Chapter 5.

organization is incorporated or whether it is organized in the United States. The power given to the Commissioner to reallocate income and deduction items is not, however, an arbitrary discretion. In cases where reallocation is necessary, the Commissioner is directed by the Regulations to determine the "true net income" of the controlled organizations involved. The true net income is that income which would have resulted to the taxpayer if it had dealt with the other members of the controlled group at arm's length.

The purpose of the section, as explained in the Regulations, is to place a controlled taxpayer ~~on a tax parity~~ with an uncontrolled taxpayer; the Commissioner's power is not restricted to cases of fraudulent or sham transactions designed to reduce or avoid tax, but extends to any case where the net income of a controlled taxpayer is different than it would have been if the taxpayer had dealt at arm's length with an uncontrolled taxpayer. It does not matter whether the control of one organization by another is direct or indirect, and the question whether there is control within the meaning of the Code is determined by the realities of the situation and not by formal distinctions. There is a presumption of control whenever income or deductions are arbitrarily shifted from one taxpayer to another.

One example, taken from a litigated case, will explain better than any general discussion the type of tax avoidance at which this section is aimed, and the effect of the application of the section. In Chapter 9 it is pointed out that foreign corporations are taxable only on income from "United States sources"; in the case of sales, for example, this means that the profit from a sale is not taxable if the sale takes place outside this country. On the other hand, any profit on a sale by a domestic corporation is taxable irrespective of the place of sale. In the *Asiatic Petroleum* case,[*] a

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* Asiatic Petroleum Co., Ltd. v. Commissioner, 79 F.2d 234 (C.C.A. 2d 1935).

parent corporation owned both a domestic and a foreign subsidiary. The domestic subsidiary held securities which had greatly appreciated in value; if they were sold by that subsidiary at the market price, the appreciation would, of course, become subject to tax. The domestic subsidiary therefore sold the securities at *cost* to the foreign subsidiary —thereby realizing no gain. The foreign subsidiary, on the following day, sold the securities in Canada at the market price; any profit realized by the foreign subsidiary would not be subject to tax since it would not be income from United States sources. The Commissioner, acting under this section, allocated the entire profit realized on the sale by the foreign subsidiary to the domestic subsidiary, since, if the transaction between the two had been at arm's length, the domestic subsidiary would not have sold at cost but would have sold at a price reflecting the profit which was received by the foreign subsidiary in the later sale. The Commissioner's reallocation of the income was upheld by the court as a proper exercise of the authority granted him by this section.

Sec. 46 (Change of Accounting Period) deals with changes in the taxpayer's accounting period, such as a change from a fiscal year to a calendar year or vice versa. This section should be read in connection with Sec. 47, below. The Regulations under Sec. 46 require a taxpayer to obtain the Commissioner's consent to a change in accounting period, and the consent must be obtained at least 60 days before the end of the "short period" (see below) for which a return would have to be filed in order to effect the change. (There are comparable Regulations under Sec. 41, above, which provide that if a taxpayer wishes to change his accounting *method,* as from a cash to an accrual basis or vice versa, he must secure the Commissioner's consent before he can use the new method for tax purposes.) The purpose of

these requirements is to prevent a taxpayer from making such a change in order to obtain some tax advantage rather than because of any real business reason.

Sec. 47 (Returns for a Period of Less Than Twelve Months) states when a return has to be filed for a "short period" and the method of determining the income for that period. If a taxpayer changes his accounting period, for example, from a calendar year to a fiscal year, there is necessarily a "short period" in between the two annual periods. If he reported, for example, for the calendar year 1947 and then obtained permission to report on the basis of a fiscal year ending on March 31st, the first full fiscal year would be April 1, 1948 to March 31, 1949. The short period is the period from January 1 to March 31, 1948. Under Sec. 47 a return must be filed for this period. There are also certain other cases where a return has to be filed for a period of less than a full year, as for example when a taxpayer dies. In that case the executor must file a return for the decedent for the short period from the beginning of the decedent's taxable year to the date of death, and another return for the estate for the period from the date of death to the end of the estate's first taxable year; this latter return will also usually be for a short period, *i.e.*, from the date of death to the end of the calendar year.

Under Sec. 47, when a return has to be filed for a short period on account of a change in the accounting period (and *only* in that case), the income of the short period has to be "annualized", that is, put on an annual basis. The general rule for annualizing income is as follows. If the short period is, say, two months, the income for that period is multiplied by twelve and divided by two in order to approximate the income that would have been received if the period had been a twelve-month period. The tax is computed on the twelve-month basis, then divided by twelve

and multiplied by two, so that it is reduced back to a two-month basis. The main reason for requiring this annualizing of income is that the tax rates, on both individuals and corporations, are progressive; if the income were not annualized, the income of the short period would be taxed at unduly low rates.

The method explained above is the "general rule" method of annualizing income. Sec. 47(c)(2) provides two other methods which can be used in certain circumstances. Under the first alternative method, the taxpayer determines his income for the twelve-month period beginning with the first day of the short period and computes the tax on that income. The tax for the short period is then the same proportion of the tax for the twelve-month period that the net income of the short period is of the net income of the twelve-month period. Under the second alternative method, the use of which is permitted only under certain circumstances, the twelve-month period is taken as the twelve months ending with the last day of the short period; the tax for the short period is then determined in the same way as under the first alternative method.

It should be emphasized again that the income of a short period has to be annualized *only* when the short period is caused by a change in the accounting period. If, for example, a return is filed for a period of less than a year because of the death of a taxpayer, the income does not have to be put on an annual basis and the tax is computed on the income of the short period only.

Sec. 48 (Definitions) is not discussed.

Sec. 51 (Individual Returns), Sec. 52 (Corporation Returns) and Sec. 53 (Time and Place for Filing Returns) set out the requirements for the filing of returns. These sec-

tions are not discussed at length as the essential requirements are either known to most readers or can be fairly readily understood from a reading of the sections. Every individual who is either a citizen or a resident of the United States must file a return if his gross income exceeds $600. A husband and wife may file a joint return; the method of computing the tax has been discussed in Chapter 2. Sec. 51(b) provides that a person who is legally separated from his spouse under a decree of divorce or separate maintenance shall not be considered as married—and such persons, therefore, can not file a joint return. Also, a joint return can not be made if either the husband or wife was a nonresident alien at any time during the taxable year. The section contains further specific provisions covering the situations where a husband and wife have different taxable years and where one of the spouses dies during the taxable year.

Nonresident aliens are also required to file returns, except in certain cases; those filing requirements are, however, discussed in Chapter 9 in connection with the general provisions applicable to nonresident aliens. An executor or administrator must file a return for an estate if the gross income is over $600; and a trustee must file a return for a trust if the gross income is over $600, or the net income over $100 (see Sec. 142). Every corporation, unless it is exempt from tax, must file a return.*

Sec. 54 (Records and Special Returns), Sec. 55 (Publicity of Returns), Sec. 56 (Payment of Tax) and 57 (Examination of Return and Determination of Tax) are not discussed.

Sec. 58 (Declaration of Estimated Tax by Individuals), Sec. 59 (Payment of Estimated Tax) and Sec. 60 (Special

* Corporations that are exempt from tax under Sec. 101 (with a few exceptions) have to file annual information returns.

Rules for Application of Sections 58 and 59) all deal with the declaration and payment of estimated tax. These sections also are not discussed. The problems involved, although at times extremely detailed, are not difficult to understand.

Sec. 61 (Laws Made Applicable), Sec. 62 (Rules and Regulations), Sec. 63 (Publication of Statistics) and Sec. 64 (Definitions) contain miscellaneous cross reference and administrative provisions and are not discussed.

Sec. 101 (Exemptions From Tax on Corporations) lists the different classes of organizations and corporations that are exempt from income tax. These corporations are not automatically exempt but are required to file an affidavit or questionnaire on certain forms that are set out in the Regulations; the Commissioner then determines whether or not the particular organization qualifies for exemption and issues a ruling to that effect. The most familiar type of organization under this section is that under Sec. 101(6) —corporations and other organizations operated exclusively for religious, charitable, and educational, etc., purposes. The organizations defined in that subsection are the same as those defined in Sec. 23(o) and Sec. 23(q) relating to deductions for charitable, etc., contributions. The main advantage that results from the tax exemption of an organization of this type is not the fact that its own income is free from tax but the fact that contributions made to it are deductible.

Sec. 102 (Surtax on Corporations Improperly Accumulating Surplus) is a very important section at the present time although in the years prior to and during the war it did

not constitute any great threat to the ordinary corporate taxpayer. Prior to the war period, the section was not aggressively enforced; and during the war period, since income subject to excess profits tax was not subject to Sec. 102 tax, the section had little application. The purpose of the section is to force corporations to distribute as dividends the corporate earnings not needed in the business, so that the dividends will be subject to surtax in the hands of the stockholders. The statute imposes a special surtax on any corporation (except personal holding companies) that is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders by means of accumulating earnings rather than distributing them as dividends.

The section does not include personal holding companies and foreign personal holding companies within its coverage since the Code contains special provisions with respect to those corporations. However, the Sec. 102 tax, and the personal holding company surtax under Subchapter A have the same general purpose—that of compelling corporations to distribute their earnings as dividends taxable to their stockholders; the income of foreign personal holding companies is, under Supplement P, taxed to citizens or residents of the United States whether or not distributed to them.

The reason for these sections lies in the difference in the rate of tax on ordinary income and on capital gain since the accumulation of corporate earnings is a way of converting present ordinary income into future capital gain. The present tax system taxes an individual's ordinary income at sharply progressive rates, while taxing capital gains at a maximum rate of 25%. Taxpayers quite naturally want to acquire income at the cost of as little tax as possible. If a corporation declares a dividend, the individual stockholder has to include the dividend in his gross income and pay tax on it at ordinary income tax rates. On the other hand, if a corporation does not declare dividends, the ac-

cumulated earnings are usually reflected in an appreciation in the value of the stock. If the stockholder thereafter sells the stock or if the corporation is liquidated, the gain representing the appreciation is subject to tax at only the capital gain rate. If the stockholder dies still owning the stock, the appreciation in value prior to death is never taxed as income (see Sec. 113(a)(5), discussed in Chapter 6). The stockholder who does not need immediate income is therefore in a far better position taxwise if the corporation, instead of declaring dividends, allows its earnings to accumulate with a resultant appreciation in the value of the stock.

Sec. 102 imposes an additional tax (in addition to the regular corporation income tax) on the "undistributed Section 102 net income" (explained below) of any corporation that comes within the scope of the section. The tax is at the rate of 27½% on the first $100,000 and 38½% on the undistributed amount in excess of $100,000.

The section applies only if the earnings are accumulated "for the purpose of preventing the imposition of the surtax" upon the stockholders. But since this makes the application of the section turn on the subjective factor of intent, the section contains two provisions in aid of the Commissioner: the fact that a corporation is a mere holding or investment company is *prima facie* evidence of the prohibited purpose (Sec. 102 (b)); * the fact that earnings are permitted to accumulate beyond the reasonable needs of the business is *determinative* of the prohibited purpose, unless the taxpayer proves the contrary by a clear preponderance of the evidence (Sec. 102(c)). As a practical matter, liabil-

* A holding company is defined in the Regulations as a corporation that has practically no activities except holding property and collecting the income therefrom; an investment company is defined as a corporation whose activities also include the buying and selling of property so that its income is derived not only from investment yield but also from profits on sales.

ity for tax under Sec. 102 usually hinges on whether the corporation has accumulated its earnings in excess of the reasonable needs of the business.

That does not mean that a corporation cannot accumulate earnings. The accumulation of earnings for additional working capital, for additions to plant and equipment, to meet maturing obligations, and for many other purposes is proper and necessary. Some of the purposes for which accumulations are proper are set out in the Regulations and others are found in the decided cases; since, however, the question is peculiarly factual, the decisions in prior cases are not particularly helpful as guides in predicting the possibility of Sec. 102 liability under different sets of facts.

The tax is imposed only on the earnings accumulated in a particular year, but the question of accumulations in past years is important in determining whether the current year's accumulations are necessary. A corporation with a large surplus accumulated in prior years would have much more difficulty in proving the necessity for accumulating any of its current earnings.

Beginning in 1939, revenue agents examining corporate returns were directed by the Bureau to pay special attention to those corporations which had paid out less than 70% of the current year's earnings to their stockholders; and for 1946 the corporate return form required a statement of the reasons for the accumulation if less than 70% of 1946 earnings were distributed. That requirement was eliminated from the 1947 return; and it is clear from the cases and from the administrative policy of the Bureau that the distribution of less than 70% of earnings does no more than direct special attention to the return. In some cases corporations can retain all their earnings without fear of Sec. 102 tax; in others, it might be difficult to show the necessity of retaining any current earnings.

Other facts, besides the percentage of earnings distributed, which revenue agents are required to consider are:

(1) whether the corporation has substantial investments in assets having no connection with the business; (2) whether the corporation has loans outstanding to stockholders or officers; and (3) whether the stock of the corporation is closely held. The existence of investments having no relation to the business, or of loans to stockholders or officers is, of course, strong evidence that the amounts so invested or loaned are not required in the business. The Bureau's concentration on closely held companies is easily explained by the difficulty of proving, even with the help of the statutory presumptions, that the directors of a publicly held company accumulate its earnings *for the purpose* of avoiding surtaxes on the shareholders. In one case,* the Bureau did challenge, successfully, a company with over 2,000 stockholders but in that case about two-thirds of the stock was held by about 20 individuals. With this success the Bureau may make further efforts to reach those companies which, though in part publicly held, are controlled and managed by a small group.

When a corporation is subject to the Sec. 102 tax, the tax is imposed on what is called the "undistributed Section 102 net income"; this term is not as formidable as it at first sounds. First, the Sec. 102 net income is determined, *i.e.*, the net income of the company after the following adjustments which are set out in Sec. 102(d). The capital loss carry-over ** and the net operating loss deduction as computed under Sec. 122 † are not allowed. Federal income taxes are deducted since that money has been or will be paid out and is not available for dividend distribution. Net

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* Trico Products Corporation, 46 B.T.A. 346 (1942), aff'd, 137 F.2d 424 (C.C.A. 2d 1943).

** This carry-over is provided by Sec. 117(e), discussed in Chapter 7.

† As explained earlier in this chapter, the Sec. 122 two-year operating loss carry-over and carry-back is not allowed for the purpose of the Sec. 102 tax; the one-year operating loss carry-over from the preceding year (Sec. 26(c)) is, however, allowed as a part of the basic surtax credit.

capital losses and excess charitable contributions, which are not allowed in computing ordinary net income, are also deducted; again, this is because those funds have been either lost or paid out by the corporation. The only further step is to determine the "undistributed Sec. 102 net income", that is, the Sec. 102 net income after deducting the basic surtax credit (with one minor adjustment). As stated earlier in the discussion of Sec. 27, the basic surtax credit is the sum of the dividends paid, the consent dividends, and the one-year operating loss carry-over from the preceding year. For the purpose of the Sec. 102 tax, the basic surtax credit is *not* reduced by the credit for partially tax-exempt interest under Sec. 26(a).

Even though the Sec. 102 tax is a penalty tax imposed in addition to the corporate normal tax and surtax, there are cases in which the aggregate tax liability (of the corporation and its stockholders) is less if the corporation deliberately accumulates its earnings and pays the Sec. 102 tax than it is if it distributes the earnings to its stockholders. That situation occurs when the surtax brackets of the stockholders are so high that the tax payable on the dividends would be greater than the sum of the Sec. 102 tax on the undistributed earnings and the maximum 25% capital gain tax payable by the stockholders on the appreciation when the stock is sold or the assets of the corporation are received upon its liquidation. In those cases, although the Sec. 102 tax is a penalty tax, it is not a sufficient penalty to force distribution. The reason that situation exists is that, since Sec. 102 was first enacted, the increase in the individual surtax rates has been proportionately greater than the increase in the Sec. 102 rates.

Sec. 103 (Rates of Tax on Citizens and Corporations of Certain Foreign Countries), Sec. 104 (Banks and Trust Companies), Sec. 105 (Sale of Oil or Gas Properties), and

Sec. 106 (Claims Against United States Involving Acquisitions of Property) are not discussed.

Sec. 107 (Compensation for Services Rendered for a Period of Thirty-Six Months or More and Back Pay) is a relief provision for individual taxpayers who receive in one taxable year compensation for personal services covering a period of years, or income from an artistic work or invention the work on which covered a period of years. The section only applies if the period during which the work was done was at least 36 months. An example of the kind of situation which the section is intended to alleviate is that of the writer who may spend several years writing a book and receive no income from the project during that period; after the book is published he may receive all in one year a large amount of royalty income which is the product of his work over the period of years. Because the income is all (or largely) received in one year, it will be taxed in higher surtax brackets than if it had been received over the period of years devoted to the writing, and (except for this section) the total tax on the royalties would be substantially greater. The general effect of this section is that, in certain prescribed circumstances, the tax on income received in one year which is the result of services or work performed over a period of years is the same as it would have been if the income had been received ratably over the period of years. The section applies to the income of either an individual or partnership, and to income either received or accrued.

Sec. 107(a) covers compensation for personal services. If 80% or more of the total compensation for personal services performed over a period of 36 months or more (from the beginning to the completion of the services) is received in one taxable year, the tax on the compensation can be computed under the relief provisions of this section. When the section applies, the tax is computed as though the

income had been received ratably over that part of the period during which the services were performed which *precedes* the receipt of the income. For example, assume that a taxpayer performed services over the 48-month period from January 1, 1944 to December 31, 1947 and received the entire compensation of $48,000 on December 31, 1947; the tax would be computed as though he had received $1,000 each month, or $12,000 in each year. If he did not receive the payment until February 1, 1948, the income would still be allocated to the same 48 months of *service.* But then assume that, although the services covered the same 48-month period, the taxpayer was paid in advance of the completion of the services; assume, for example, that he was paid the full amount on April 30, 1947. In that case, the income would be prorated over the period of service preceding the receipt of the income, that is, the 40-month period from January 1944 to April 1947.

The returns for the earlier years are not adjusted and the taxes for the earlier years are not affected. For instance, in the example given above, the income of $48,000 remains income of 1947; this section merely provides that the *tax* on the income shall not be greater than the taxes which would have been payable if the income had been received ratably over the period specified. The section provides a limitation on the *tax,* and does not convert the income into income of the earlier years

Sec. 107(b) covers income from an artistic work or invention (as defined in that section) when the work of the taxpayer on such artistic work or invention covered a period of 36 months or more. There is a different problem here than in the case of personal services. A taxpayer ordinarily knows the amount he will receive for personal services covering a long period of time, and therefore can determine whether the amount received in one taxable year is 80% or more of the total compensation. But the person who writes a book, for example, and receives large royalties

in one year cannot know whether those royalties amount to 80% or more of the total royalties he will ever receive from the book. The provisions of this section are, therefore, somewhat different from the provisions covering income from personal services. Under this section, if the amount received in one year is 80% or more of the total amount received from the artistic work or invention in (1) all preceding years, (2) the taxable year, and (3) the twelve months following the taxable year, the section applies. When the section does apply, the tax is computed as though the income had been received ratably over that part of the period during which the work was performed which precedes the close of the taxable year, but in no event over a period of more than 36 months. The Regulations give examples of the method of allocating income under both Sec. 107(a) and Sec. 107(b).

Sec. 107(d) contains provisions limiting the tax on certain amounts of back pay received in a taxable year to the amount of tax that would have been payable if the back pay had been included in the taxpayer's gross income in the years to which the back pay is attributable. This section is not discussed.

Sec. 108 (Fiscal Year Taxpayers) covers the computation of the tax of fiscal year taxpayers with taxable years ending in 1948 and in certain prior years during which there were changes in the tax rates and in other provisions of the Code. Because of those changes, fiscal year taxpayers are required to compute a part of their tax according to one set of provisions and a part according to a different set. This section is not discussed.

Sec. 109 (Western Hemisphere Trade Corporations) relates to a particular type of corporation called a "Western

Hemisphere Trade Corporation". This section merely defines what a western hemisphere trade corporation is. However, under Sec. 15, these corporations are not subject to surtax, but are subject to normal tax only. The purpose in granting this exemption is to allow these domestic corporations to compete effectively with local corporations and corporations of other foreign countries which are also doing business in countries in the western hemisphere. Our corporate tax rates are higher than those of a number of other countries; and, since taxes are an essential cost of doing business, corporations organized in this country are at a competitive disadvantage if their taxes are higher than those of foreign corporations operating in the same competitive area. The exemption of these western hemisphere trade corporations from surtax is, and is intended as, a subsidy.

In order to be taxed as a western hemisphere trade corporation, a corporation must meet all of the following requirements:

1) It must be a domestic corporation.

2) All of its business must be done in countries in North, Central or South America, or in the West Indies or in Newfoundland.

3) 95% or more of its gross income must be derived from sources other than sources within the United States; this requirement must be met for the taxable year and the two preceding years, or for such part of that period as the corporation was in existence.

4) 90% or more of its gross income must be derived from the active conduct of a trade or business.

Requirements numbered 3) and 4) above need to be examined with some care. Requirement number 3) refers to gross income from sources other than sources within the United States. The source of gross income—whether it is a source within the United States or a source without the United States—is determined under Sec. 119 (discussed in Chapter 7). As merely one example, if a corporation is a

sales corporation, the source of the income depends on where the sales are made; if such a corporation wishes to qualify as a western hemisphere trade corporation, its sales must be made in such a way that they take place outside the United States. Under requirement number 4) above, 90% of the gross income must be derived from the active conduct of a trade or business. If, for example, 15% of the gross income is derived from dividends or interest, the corporation cannot qualify as a western hemisphere trade corporation.

Since a western hemisphere trade corporation is doing business in a foreign country, it is, of course, subject to whatever income taxes are imposed by that country. The foreign tax can, however, be credited against the United States tax, under the provisions of Sec. 131 (discussed in Chapter 8); the general effect of that section is that the corporation pays, in the aggregate, the higher of the two taxes —the United States tax or the foreign tax. In any case where the foreign tax is lower than the combined federal normal tax and surtax there is a tax advantage to be gained by operating the company as a western hemisphere trade corporation.

CHAPTER 5

SECTION 111 AND SECTION 112

Introduction. The sections discussed in this and the following chapter are the most difficult and technical of any of

the Code sections that are of general application. Since they are of general application, however, some knowledge of them is essential to an understanding of the tax effects of many very common transactions. These sections are concerned with sales, exchanges, and other dispositions of property and deal respectively with the *realization* of gain or loss (Sec. 111), the *recognition* of gain or loss (Sec. 112), and the *basis* of the property (Sec. 113).

As has been stated before, gain must be *realized* before it is taxed; mere appreciation in value is not taxed. Sec. 111 provides the rules for determining the amount of gain or loss that is realized on a sale, exchange or other disposition of property. Sec. 112 provides the rules for determining whether a gain or loss that is realized is *recognized* for tax purposes, that is, whether the transaction has any immediate tax effect. Sec. 113, in its various subsections, provides the rules for determining the basis of property, which basis varies depending on the manner in which the property was acquired.

It should be emphasized that Sec. 112 and Sec. 113 are closely interrelated. When gain or loss is not recognized under the provisions of Sec. 112, it does not mean that the gain is never taxed or the loss never allowed; because of the applicable basis provisions of Sec. 113, the recognition of gain or loss is merely postponed until some future date when a taxable transaction occurs. These basis provisions are discussed in detail in the following chapter. The general effect of the interrelation of Sec. 112 and Sec. 113 can be illustrated by a simple example. Assume that a taxpayer exchanges stock in corporation A, with a basis of $1,000 and a fair market value of $1,500, for stock in corporation B with a fair market value of $1,500. If the exchange is a taxable transaction, not within Sec. 112, the gain of $500 is recognized and taxed; in this case the B stock has a cost basis in the taxpayer's hands of $1,500, the value of the property exchanged for it. If, however, the exchange is

one in which gain is not recognized under the provisions of Sec. 112, the gain of $500 is *not* taxed at the time of the exchange; in this case, because the gain is not taxed, the B stock received by the taxpayer has a basis of $1,000, the same basis as that of the A stock given in exchange.* It is only in the first case, where the gain is taxed, that the taxpayer's basis is increased to $1,500, the fair market value of the property given up.

Sec. 111 (Determination of Amount of, and Recognition of, Gain or Loss) provides that the gain or loss on the sale, exchange or other disposition of property is the difference between (1) the "amount realized" from the sale, exchange or other disposition and (2) the "adjusted basis" of the property. The "amount realized" is the sum of any money received plus the fair market value of any property other than money received. If, for example, A sells property and receives as the proceeds of the sale $5,000 in cash and stock or other property with a fair market value of $3,000, the "amount realized" is $8,000. The other factor, the "adjusted basis", is determined under Sec. 113, discusssed in Chapter 6.

There must, of course, be a "disposition" of property before any gain or loss is realized. As long as the taxpayer retains the property, he realizes no gain by an increase in its value nor can he take any deduction for a decline in value. A *sale* of the property is not essential to a realization of gain or loss; any exchange or other disposition, such as an exchange of one property for another or a transfer of the property to a creditor in payment of a debt, is sufficient.

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* The basis rules differ for different types of tax-free exchanges. The rule stated is the rule applicable to tax-free exchanges generally, under Sec. 113(a)(6).

Sec. 112 (Recognition of Gain or Loss)

Sec. 112 provides that upon a sale, exchange or other disposition of property the entire amount of the gain or loss shall be recognized except in certain specific transactions described in that section. The reason for the non-recognition of the gain or loss realized in certain exchanges is that in those exchanges, although the taxpayer exchanges one property for a different property, there is not a sufficient difference between the two properties to make it appropriate to tax the gain or allow the loss at that time. The general types of exchanges that are tax-free * can be illustrated by a few examples. As the simplest example, a taxpayer might exchange one share of common stock for four shares of common stock of the same corporation in a stock split-up; this is an exchange, but the difference between the property parted with and the property received is merely a difference of form. As a further example, a taxpayer might exchange unimproved land for a parcel of improved real estate; here, while the specific property changes, the general character of the taxpayer's investment remains the same. As one more example, a taxpayer owning stock in corporation A might, upon a merger of that corporation into corporation B, receive B stock in exchange for his old shares of A stock; here, the taxpayer retains his interest in the specific business enterprise although in altered form. In all these cases, the change is considered one of form rather than one of substance and no gain or loss is recognized, on the general theory that merely formal differences should not give rise to taxable income or deductible losses.

As stated above, when gain or loss is not recognized under the provisions of Sec. 112, the tax on the gain or the

* The term "tax-free" is commonly used in referring to exchanges or other dispositions of property upon which gain or loss is not recognized, even though such transactions are actually not "tax-free" but only "tax-postponed".

deduction of the loss is merely postponed. The theory of the tax law is that the new property received on the exchange is a continuation of the taxpayer's investment in the old property. Therefore, when a taxpayer exchanges one property for another, he has as his basis for the new property the basis which he had for the property given up in the exchange.*

Sec. 112(a) (General Rule) states the general rule that the entire amount of gain or loss on the sale or exchange of property, determined in accordance with the provisions of Sec. 111, is recognized for tax purposes *unless* the transaction comes within one of the exceptions provided in Sec. 112. A "sale" ordinarily connotes a transfer of property for cash and in such transactions gain or loss is recognized. The exceptions under Sec. 112 refer to transactions where property is exchanged for other property, or for other property together with cash.

Sec. 112(b) (Exchanges Solely in Kind) provides the rules with respect to exchanges that are *solely* in kind and in which no gain or loss is recognized. There are, of course, transactions where the exchange is not solely in kind—as, for example, where money constitutes part of the consideration received on the exchange. Those are ordinarily called "boot transactions"; the provisions covering those transactions are contained in Secs. 112(c) and 112(d). The exchanges under Sec. 112(b) which are exchanges *solely* in kind and in which no gain or loss is recognized are discussed first.

Sec. 112(b)(1) (Property Held for Productive Use or Investment) provides that no gain or loss is recognized if property which is held either (1) for productive use in a trade or

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* In one situation, the liquidation of a subsidiary under Sec. 112(b)(6), there is a different basis rule; that is discussed in Chapter 6.

business or (2) as an investment is exchanged solely for property of a *like kind* which is also held either for productive use in a trade or business or as an investment. This exception does *not* apply to stock in trade or other property held primarily for sale, or to stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, irrespective of the purpose for which held.

Under this section, the property given* and received on the exchange must be of a like kind. For example, if a taxpayer exchanges real estate with a basis of $10,000 for other real estate worth $15,000 (both being held for investment), the exchange is of property of like kind and the gain of $5,000 is not recognized; but if he exchanges real estate for a truck the exchange is not within this section since the properties are not of like kind. The Regulations give several examples of exchanges in which the properties are of like kind. When an exchange comes within the provisions of this section, the basis of the old property is carried over to and becomes the basis of the new property (under Sec. 113(a)(6)). In the example above, the real estate received in the exchange would have a basis in the taxpayer's hands of $10,000 although its value was $15,000.

It is often important to determine whether property is held for use in a trade or business or as an investment or whether it is held primarily for sale, since in the latter case this section does not apply. Suppose, for example, that a taxpayer owns several pieces of real estate, either improved or unimproved. If he operates the properties to obtain rental income or holds them for a future appreciation in value, the properties are considered as held for use

* Throughout this chapter the terms "give" and "receive" are frequently used in connection with exchanges to distinguish between the property parted with and the property received. The term "give" is used for convenience only and carries no connotation of a gift in the legal sense, that is, a transfer without consideration.

in the business of renting or as an investment; if, then, the taxpayer exchanges one piece of real estate for a different piece (to be devoted to the same use), the exchange comes within the provisions of this section. But, if the taxpayer is a dealer in real estate and holds the properties primarily for sale in the course of his business, an exchange of one property for another does not come within this section and any gain or loss is recognized.

If a taxpayer exchanges property together with cash for other property of a like kind, both properties being used in the trade or business or held as an investment, the transaction comes within this section and gain or loss is not recognized. But if the taxpayer exchanges property and *receives* (rather than *gives*) on the exchange property of a like kind together with cash, the transaction is not within this section but is instead an exchange "not solely in kind" within the provisions of Sec. 112(c) (discussed below). The difference is that in the first case the taxpayer gives property together with cash (for example, an old truck plus cash) and receives in exchange the new property (for example, a new truck); the old property represents a part of the consideration for the new property so that the old property is given solely in exchange for the new property. In the second case, the taxpayer comes out of the transaction with some cash in hand, so that the property given up is not exchanged *solely* for property of a like kind but is exchanged for property of a like kind *and* cash. An exchange of the latter type is a boot transaction within the provisions of Sec. 112(c). This general principle is equally true with respect to exchanges under other subsections of Sec. 112(b). If cash is *given* as part of the consideration, the exchange of the property is still an exchange solely in kind (provided all other requirements are met); but, if cash is *received* on the exchange, the exchange is not solely in kind and comes within the provisions of Sec. 112(c) (if all other requirements are met).

Sec. 112(b)(1)

As noted above, Sec. 112(b)(1) does not apply to exchanges of stocks, bonds, and other securities. Such exchanges may, however, be tax-free if they fall within the provisions of later subsections.

Sec. 112(b)(2) (Stock for Stock of Same Corporation) is almost self-explanatory; it provides that gain or loss is not recognized if (1) common stock in a corporation is exchanged solely for common stock in the *same* corporation or (2) preferred stock in a corporation is exchanged solely for preferred stock in the *same* corporation. This section does *not* apply if the exchange is of common stock for preferred stock, or of stock for bonds, or of stock in one corporation for stock in another corporation; exchanges of those types may, however, be tax-free under Secs. 112(b)(3) and 112(b)(4) if they are made in connection with a reorganization.

Sec. 112(b)(3) (Stock for Stock on Reorganization), Sec. 112(b)(4) (Same—Gain of Corporation), and Sec. 112(g) (Definition of Reorganization):—Reorganizations. The next two sections, Sec. 112(b)(3) and Sec. 112(b)(4), and also Sec. 112(g) deal with reorganizations and have to be considered together.* Sec. 112(b)(3) covers exchanges by stockholders; Sec. 112(b)(4) covers exchanges by the corporations taking part in the reorganization. Sec. 112(g) specifies what is a reorganization for tax purposes; two concepts developed by case law—the necessity of a continuity of interest and the necessity of a business purpose—have also to be considered in connection with the statutory definition in that section. One very important point to keep in mind is that reorganization exchanges are tax-free only if they meet *both* the following requirements: (1) the transaction

* Sec. 112(c) and Sec. 112(d) also apply to reorganization transactions; they are discussed later in this chapter.

must be a "reorganization" within one of the definitions of Sec. 112(g) and (2) the exchange must be of a type set out in either Sec. 112(b)(3) or Sec. 112(b)(4). The first question is always whether the transaction itself is a "reorganization".

—**Sec. 112(g) (Definition of Reorganization)** lists six types of transactions which are "reorganizations" within the meaning of the tax law.* The fact that a transaction is a reorganization under the corporation laws of a state does not determine the *tax* effects of the transaction; it must be a reorganization within the intent and within one of the definitions of Sec. 112(g). Under that section, the term "reorganization" means:

Clause A: a statutory merger or consolidation—that is, a merger or consolidation effected under the corporation laws of the United States or a State or Territory or the District of Columbia.

Clause B: the acquisition by one corporation, in exchange solely for all or a part of its *voting* stock, of at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock of another corporation. Under this clause, if corporation A acquires at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock of corporation B, and A gives in exchange *only* its own voting stock, there is a reorganization. But if A gives in exchange voting stock and also preferred stock or bonds, or any other property, there is not a reorganization under this clause (although there may be a reorganization under Clause A).

Clause C: the acquisition by one corporation, in exchange solely for all or part of its *voting* stock, of *substan-*

* The provisions of Sec. 112(g) are explicit and unqualified; they are, nevertheless, limited by the judicially developed doctrines of continuity of interest and business purpose which are discussed below.

tially all the properties of another corporation. In determining whether the properties are acquired solely in exchange for voting stock, the assumption by the acquiring corporation of a liability of the other, or the fact that the property acquired is subject to a liability, is disregarded. If, for example, corporation A acquires substantially all the properties of corporation B and assumes B's liabilities or takes the assets subject to liabilities, the acquisition will qualify as a reorganization if corporation B or its stockholders receive only voting stock of A.

It should be noted that under Clause B the corporation is acquiring *stock* so that the acquired corporation becomes a subsidiary, while under Clause C the corporation is acquiring assets. The particular requirement under Clause C is that the acquiring corporation must acquire *substantially all* the properties of the other corporation. There is no rigid rule as to what is substantially all. In certain cases percentages ranging from 85% to 91% have been held to be substantially all the assets. Whether a particular percentage meets the requirement depends to a large extent on the nature of the assets retained by the transferring corporation; if, for example, the retained assets consist only of cash or other liquid assets which are to be used to discharge liabilities, the percentage of assets transferred can be less than would otherwise be necessary to meet the requirement of the statute.

The requirement of a transfer of substantially all the assets cannot be avoided, however, by a device of the type that was tried unsuccessfully in the *Elkhorn Coal* case.[*] In that case, the original company (called here Elkhorn) wanted to transfer certain coal mining properties to corporation X, but the properties did not constitute substantially all its assets. It therefore organized a new corporation, S, and transferred to it all the assets not wanted by X, in ex-

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[*] Helvering v. Elkhorn Coal Co., 95 F.2d 732 (C.C.A. 4th 1938).

change for the stock of S which was then distributed to the Elkhorn stockholders. At that point Elkhorn owned only the mining properties. Elkhorn then transferred the mining properties to X in exchange for stock of X and claimed that the transfer met the requirement of the statute since it was a transfer of substantially all of Elkhorn's then assets. Later, S acquired the Elkhorn stock and liquidated that company. The Elkhorn stockholders ended up owning stock of corporation S which corporation in turn owned X stock and all the original Elkhorn assets other than the coal mining properties. These were the same assets that Elkhorn would have had if it had, in the first place, merely transferred the mining properties to X in exchange for X stock. The court held that the organization of S was a sham device with no purpose other than tax avoidance; and hence that the transfer of the mining properties by Elkhorn to X was not a transfer of substantially all the assets of Elkhorn.

Both Clause B and Clause C of the reorganization definition require that the acquisition of the stock or assets must be in exchange solely for *voting* stock of the acquiring corporation. The reason for this requirement is that the reorganization sections are intended to apply only to transaction in which the persons who were the owners of the enterprise prior to the reorganization continue to have an interest in the enterprise after the reorganization. This doctrine of continuity of interest is discussed further below. In Clause B and Clause C reorganizations, the necessity for a continuing interest is written directly into the statute, but the requirement also exists with respect to reorganizations under the other clauses. In a Clause B reorganization, if a taxpayer exchanges stock in corporation A for voting stock of the acquiring corporation B, he necessarily retains an equity interest in the enterprise through his holdings of the parent corporation's stock. In a Clause C reorganization, if assets of corporation A are acquired by corporation B solely in exchange for voting stock of B, the stockholders of

corporation A have a continuing interest in the enterprise either through their indirect ownership of the stock of B (if A is kept alive as a holding company), or through their direct ownership of the stock of B (if A is liquidated).

Clause D: a transfer by a corporation (A) of *all* or a *part* of its assets to another corporation (B), if immediately after the transfer the transferor (A) or its stockholders or both are in control of the transferee corporation (B). This clause covers the type of reorganization in which a corporation splits itself into two parts, in contrast to the reorganizations under Clauses A and C where two or more enterprises are combined in one operating corporation. The particular requirement under Clause D is that the transferring corporation or its stockholders or both must be in *control* of the transferee corporation immediately after the transfer. "Control" is defined in Sec. 112(h) as meaning the ownership of stock possessing at least 80% of the combined voting power of all classes of voting stock together with the ownership of at least 80% of the total number of shares of all other classes of stock.

Control of the transferee corporation must be in the transferring corporation or its stockholders or both *immediately after* the transfer. This requirement has been interpreted by the courts in such a way as to exclude from reorganizations under this clause transfers that meet only the literal requirement of the statute. For example, assume that corporation A transfers a part of its assets to corporation B in exchange for all of B's stock; corporation A is clearly in control of B *immediately* after the transfer. But if there was a pre-existing agreement between corporation A and a third person, C, whereby A was to sell a third of the B stock to C for cash, and the stock was transferred to C in accordance with that agreement, the transaction would not qualify as a reorganization. The courts take the position that, in determining whether control vests in the transferor immediately after the transfer, all the steps agreed to must

be considered. This is a problem in what are called "step transactions"; it is often difficult to determine in advance when technically independent transactions will be considered as merely steps in an overall plan which will be treated as a unit.

Clause E: a recapitalization. Reorganizations under this clause differ from those under the foregoing clauses in that in Clause E reorganizations only one corporation is involved. There is a recapitalization, under the Regulations, if a corporation issues preferred stock in exchange for its outstanding bonds; or issues common stock in cancellation of outstanding preferred stock; or issues preferred for outstanding common. Although the Commissioner has argued to the contrary, the courts have held that an exchange of bonds for bonds is also a recapitalization under this clause. At the present time, the question whether there is a business purpose for a reorganization (discussed below) is particularly important in connection with recapitalizations.

Clause F: a mere change in identity, form or place of organization, however effected. This clause is not particularly important since reorganizations that would qualify under it would ordinarily also qualify under some other clause. There would be a reorganization under this clause, for example, when a corporation changes its state of incorporation.

If a transaction falls within one of the clauses of Sec. 112(g), outlined above, (and also meets the additional requirements which have been developed by judicial law), the second step is to determine whether the exchanges in connection with the reorganization are tax-free under either Sec. 112(b)(3) or Sec. 112(b)(4). Even though a particular transaction qualifies as a reorganization, the exchanges will not be tax-free unless they come within the provisions of one of those two sections.

—Sec. 112(b)(3) (Stock for Stock on Reorganization) deals with the exchanges made by the *stockholders* of a cor-

poration which is a party to a reorganization. No gain or loss is recognized to a stockholder if he transfers *stock or securities* in a corporation that is a party to a reorganization and receives solely *stock or securities* of the same corporation or of another corporation that is a party to the reorganization, provided that the exchange is in pursuance of a plan of reorganization. Assume, for example, that corporation A is merged into corporation B in a statutory merger; and that a common stockholder, X, pursuant to the plan of merger, turns in his old stock of corporation A, with a basis of $10,000, and receives in exchange common and preferred stock of B with a fair market value of $12,000. The transaction is a reorganization under Clause A; and the gain of $2,000 is not recognized since X is exchanging securities of corporation A for securities of corporation B, both of which corporations are parties to the reorganization, and since the exchange is pursuant to the plan of reorganization. If, however, X received on the exchange, in addition to the B stock, cash or "other property",* the exchange would not be *solely* for stock or securities of a corporation a party to the reorganization and would not be entirely free from tax; this exchange would then fall within the provisions of Sec. 112(c), discussed below.

—**Sec. 112(b)(4) (Same—Gain of Corporation)** deals with the exchange made by the *corporation* that is a party to the reorganization, as distinguished from the exchanges made by the stockholders. No gain or loss is recognized to a corporation, a party to a reorganization, which transfers property, in pursuance of a plan of reorganization, and receives in exchange solely stock or securities of another corporation which is a party to the reorganization. This section refers

* The term "other property" as used in Sec. 112 includes all property received on an exchange except stock and securities of a corporation a party to a reorganization and money. Short-term notes are not considered "securities"—see footnote page 155.

only to the corporation that transfers property and receives securities, and not to the corporation that issues securities and receives property. Assume, for example, that in a reorganization under Clause C corporation A acquires all the assets of corporation B in exchange solely for voting stock of A; and assume, further, that the assets transferred by B have a basis of $500,000 and a fair market value of $750,000; and that the stock of A received in exchange has a fair market value of $750,000. Under Sec. 112(b)(4), the transfer by corporation B of its assets in exchange for the securities of corporation A is tax-free and the gain of $250,000 is not recognized or taxed to B. When the transaction is looked at from the viewpoint of corporation A, it may be noticed that there is no section providing that gain or loss is not recognized to the corporation that acquires assets in exchange for its securities. This is because the acquiring corporation is *acquiring* rather than *disposing* of assets; and gain or loss is ordinarily not realized when property is purchased, but only when it is sold.*

—**Terminology.** There are three important terms used in both Sec. 112(b)(3) and Sec. 112(b)(4): "securities", "a corporation a party to a reorganization", and "the plan of reorganization". The term "securities" includes both common and preferred stock and long-term bonds. It has been held, however, not to include short-term notes. If common stock together with short-term notes are received on an exchange, the exchange is, therefore, not "solely in kind" under Sec. 112(b) but comes within the provisions of Sec. 112(c) or Sec. 112(d), since the notes are treated as "other property".

The term "a party to a reorganization" is defined in Sec. 112(g)(2) as including a corporation resulting from a re-

* There are a few exceptions to this rule such as bargain purchases by corporate employees and stockholders, discussed in Chapter 2; in those cases gain is deemed to result from the purchase.

organization (as in a statutory merger or consolidation or a reorganization under Clause D), and both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another (as in a Clause B or Clause C reorganization). The securities received on an exchange under Sec. 112(b)(3) and Sec. 112(b)(4) must be securities of a corporation that is a party to the reorganization in order for the exchange to be tax-free; if securities of another corporation are received on the exchange, they are treated as "other property" within the terms of Sec. 112(c) and Sec. 112(d). The two leading cases on the question of what corporations are parties to a reorganization are the *Groman* and *Bashford* cases.* While the facts in both cases were very similar, those of the *Groman* case can be more easily summarized.

In that case the Glidden company organized an Ohio corporation and held all of the common stock of Ohio but not the preferred; the Ohio company then acquired the stock of an Indiana company and gave in exchange to the Indiana stockholders (1) preferred stock of Ohio, (2) cash, and (3) prior preference stock of Glidden. There was no argument as to the preferred stock of Ohio since that clearly came within the non-recognition provisions, and no argument as to the cash since that clearly did not come within those provisions; the question was whether the prior preference stock of Glidden was stock of a corporation a party to the reorganization. The Court held that it was not; that while Glidden was a party to the reorganization agreement, it was not a party to the reorganization itself. The Court's position was that Glidden was merely an agent in bringing about the reorganization, and that its activities were comparable to those of a banking corporation which subscribes

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* Groman v. Commissioner, 302 U.S. 82 (1937); Helvering v. Bashford, 302 U.S. 454 (1938).

to stock of a new corporation, thereby providing it with capital.

The exchanges must also be made in pursuance of a *plan of reorganization.* The plan must be adopted by all the corporations that are parties to the plan and its adoption must appear on the records of the corporations. Each corporation must file with its income tax return for the taxable year of the reorganization a statement of all the facts pertinent to the transaction. The information that needs to be filed is set out in the Regulations.

—Concepts Developed by Case Law. The discussion of reorganizations up to this point has been concerned only with the statutory requirements. However, in order for a given transaction to qualify as a reorganization it must not only meet those statutory requirements but must also meet two other requirements developed by the cases. The two judicially developed doctrines are (1) the continuity of interest rule and (2) the business purpose rule.

Continuity of Interest. The continuity of interest rule is now set out in the Regulations which state that there must be (1) a continuity of the business enterprise under a modified corporate form and (2) a continuity of interest on the part of the persons who were the owners of the enterprise prior to the reorganization. The law recognizes, for example, that there is a continuity of the business enterprise when two corporations are amalgamated to carry on jointly the business previously carried on by the separate corporations, or when a business that was previously carried on by a single corporation is continued by a parent and a subsidiary. But there must also be a continuity of interest in the particular enterprise on the part of those persons who were the owners of the enterprise prior to the reorganization.

Under this latter rule, the continuing interest of the prior

owners of the enterprise must be represented by an equity, and not a creditor, interest in the enterprise after the reorganization. As stated before, this requirement is written directly into the statute in the case of a reorganization under Clause B or Clause C, since in those reorganizations the transferors of the stock (Clause B) or of the assets (Clause C) must receive only voting stock of the transferee in the exchange; the transferors by necessity, therefore, retain a continuing equity interest in the enterprise. The requirement of a continuing interest also exists, however, with respect to reorganizations under the other clauses of Sec. 112(g). In reorganizations under the other clauses, the requirement is met if the transferors receive either common or preferred stock in the exchange. This does not mean that the transferors must receive *only* common or preferred stock. They can also receive bonds or short-term notes * or cash together with the stock so long as the stock represents a substantial part of the total consideration. No rules can be laid down as to the percentage of the consideration that must be in the form of stock in order to meet the continuity of interest rule; this is still one of the very tangled and unsettled fields of the law. For that reason, in actual

* Long-term bonds do not of themselves provide a continuing interest but, if the transferor receives stock and long-term bonds and the stock represents a substantial proportion of the total consideration, the continuity of interest requirement is met and the transaction can qualify as a reorganization. The long-term bonds are also "securities" within the meaning of Sec. 112(b)(3) and Sec. 112(b)(4) and are received by the transferor without the recognition of gain or loss. The rule as to the recognition of gain or loss on the receipt of short-term notes is different. As in the case of long-term bonds, if the transferor receives stock and short-term notes, the stock representing a substantial proportion of the total consideration, the continuity of interest requirement is met and the transaction can qualify as a reorganization. But, when the exchanges under Sec. 112(b)(3) and Sec. 112(b)(4) are considered, short-term notes are ***not*** securities and are treated like cash or other property and gain or loss is recognized, under the provisions of Sec. 112(c) and Sec. 112(d), to the extent of the value of the notes.

practice, many corporations contemplating a reorganization present their proposed plan to the Commissioner and obtain an advance ruling on the tax consequences.

Business Purpose. The second judicially developed doctrine is the business purpose rule. Under that rule, a transaction which meets all the literal requirements of the statute still does not qualify as a tax-free reorganization unless there is a "business purpose" for the reorganization. This rule is set out in part in the Regulations which state that the purpose of the reorganization provisions is to except from the general rule (under which gain or loss is recognized) only those exchanges that are made in connection with corporate readjustments required by business exigencies; and that a scheme which involves an abrupt departure from normal reorganization procedure and which is devised and adopted in connection with a transaction on which the imposition of tax is imminent is not a plan of reorganization within the meaning of the Code.

The business purpose rule has developed out of the fact that the statutory provisions taken literally provide many opportunities for tax avoidance. It was first enunciated by the Supreme Court in the *Gregory* case * and is still often called the "Gregory rule". This business purpose rule was also the determining factor in two recent important cases involving recapitalizations—the *Bazley* and *Adams* cases ** which involved very similar facts. The facts of the *Gregory* and *Bazley* cases are stated below in some detail since the business purpose rule can be understood more easily through examples than through exposition.

In the *Gregory* case, Mrs. Gregory was the sole stockholder of the United Mortgage Corporation; that corporation owned 1,000 shares of stock in the Monitor Corporation.

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* Gregory v. Helvering, 293 U.S. 465 (1935).

** Bazley v. Commissioner, 331 U.S. 737 (1947); Adams v. Commissioner, 331 U.S. 737 (1947).

Mrs. Gregory wanted to sell the Monitor stock but wanted to avoid the tax that would be payable if the Monitor shares were first distributed to her as an ordinary dividend. She therefore had United Mortgage transfer the Monitor stock to a newly formed subsidiary, called Averill, in exchange for all Averill's stock. United Mortgage then distributed the Averill stock to Mrs. Gregory. (The creation of Averill followed exactly the definition of a reorganization in Clause D of Sec. 112(g); and the distribution of the Averill stock to Mrs. Gregory was tax-free under the law at the time the transaction took place, although it would not be under the present statute.*) Three days later, Averill was dissolved; Mrs. Gregory received the Monitor stock as a liquidating distribution, and then sold the stock. She paid a capital gain tax on the difference between the amount received for the Monitor stock and the basis for the Averill stock (an apportioned part of her basis for the United Mortgage stock). The Supreme Court held that, although there was literal compliance with the terms of the statute, the creation of Averill was not a reorganization within the intent of the statute since it served no business purpose. Averill existed only for the purpose of transferring the Monitor stock to Mrs. Gregory as a liquidating dividend instead of as an ordinary dividend; except for the tax effects, the Monitor stock could just as well have been distributed by United Mortgage directly to Mrs. Gregory. The effect of the Court's decision was to ignore the creation and liquidation of Averill and to treat the amount received on the sale of the stock as an ordinary dividend received by Mrs. Gregory.

The *Bazley* case involved a recapitalization in which a corporation issued bonds and stock in exchange for pre-

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* Under the present law, as set out in the Regulations (Sec. 29.112 (g)-5), a distribution of stock or securities in connection with a plan of reorganization is not tax-free unless the stockholder surrenders stock in exchange therefor.

viously outstanding stock. Prior to the recapitalization, the corporation had only one class of stock outstanding. It issued in exchange for each share of old stock five shares of new stock and $400 in long-term debenture bonds. The Court held that the recapitalization was not a reorganization under Sec. 112 but was merely a vehicle for the distribution of earnings to the stockholders. Nothing was accomplished by the recapitalization that could not have been equally accomplished by the distribution of a taxable dividend in the form of debentures. The Tax Court opinion in the case drew a distinction, which was accepted in the Circuit Court opinion, between a "corporate" purpose and a "stockholder" purpose. There was no doubt that there were several legitimate stockholder purposes for the recapitalization in that, among other things, the stockholders received for part of their investment a more readily marketable security, and to the extent of the bonds received ranked equally with creditors in what was a hazardous business. But the court held that these were merely reasons for the *stockholders'* desire to change the form of their investment and did not amount to a legitimate *corporate* purpose for the reorganization. (This distinction made by the court between a stockholder purpose and a corporate purpose is well illustrated by one argument made by the taxpayer in the *Adams* case. There, the taxpayer argued that there was a corporate purpose in the issuance of the bonds since the corporation's income tax would be reduced by reason of the deduction allowed for interest paid on the bonds; the Tax Court pointed out that, so far as the *corporation* was concerned, the issuance of the bonds was a disadvantage rather than an advantage since the corporation was saddled with a fixed annual interest charge far greater than the income tax saving.)

The effect of the decision in both the *Bazley* and *Adams* cases was that the fair market value of the bonds was taxed as an ordinary dividend to the stockholders (to the extent

of the earnings and profits of the corporation). The reason why taxpayers attempt this type of recapitalization is twofold. In the first place, the corporation would obtain a deduction for the interest paid on the bonds, whereas the dividends paid on its stock are not deductible; the corporate tax would thereby be reduced. In the second place, the stockholder would be able to divide his investment in the corporation between stock and bonds; he could then sell the bonds and pay only a capital gain tax on the difference between the selling price and his basis for the bonds (an apportioned part of his basis for the original stock).* By this process, he is able—or would be if the transaction were not challenged—to draw out part of the corporation's accumulated earnings at the cost of only a capital gain tax on a part of the proceeds of sale, whereas if he received the earnings as an ordinary dividend he would have to pay tax on the full amount at ordinary income tax rates.

The case law is extremely important in connection with many phases of reorganizations but because of the scope of this book it cannot be dealt with here in any detail. Besides the cases that have been mentioned, there are many important decisions in connection with the continuity of interest rule and the business purpose rule; there are also important cases on the questions of what corporations are parties to a reorganization, what types of instruments are "securities" within the meaning of Sec. 112(b)(3) and Sec. 112(b)(4), what are "substantially all the properties" in a Clause C reorganization, under what circumstances a transferor is in control of the transferee corporation "immediately after the transfer" in a Clause D reorganization, and what individual steps will be treated as part of an overall plan in step transactions. The whole subject of reorganizations

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* If the bonds were redeemed rather than sold, he would also pay only a capital gain tax on the difference between the redemption price and his basis for the bonds. See Sec. 117(f) discussed in Chapter 7.

is complicated and technical; both the statute and the decisions must be carefully studied in considering a particular transaction.

Sec. 112(b)(5) (Transfer to Corporation Controlled by Transferor) deals with transfers of property to a corporation in exchange for stock or securities. It applies primarily to the organization of a corporation (rather than its reorganization). The section provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities of the corporation and if immediately after the exchange the transferor or the transferors are in control of the corporation; there is a further requirement that, if there is more than one transferor, the stock or securities received by each must be substantially in proportion to his interest in the property transferred.*

Under this section, if an individual, X, who has been operating a business as a sole proprietor incorporates his business, transfers the assets to the corporation in exchange solely for its stock, and continues to operate the business as a corporation, no gain or loss is recognized on the transfer of the assets to the corporation. The assets might have had, for example, a basis of $50,000 in X's hands and a value at the time of the transfer of $75,000; he can transfer them to the corporation in exchange for its stock and the gain of $25,000 is not recognized. Under Sec. 113(a)(6) and Sec. 113(a)(8) (the relevant basis provisions) the stock will have a basis in X's hands of $50,000 and the assets will retain a basis in the hands of the corporation of $50,000. Sec. 112(b)(5) would also apply even if X did not receive all the stock of the corporation in exchange for the assets so long

* In many cases of the general type covered by Sec. 112(b)(5) the taxpayer does not desire a tax-free exchange, but prefers instead to pay a capital gain tax on the transfer in order that the corporation may acquire a higher basis (for depreciation or on sale) for the assets it receives.

as he received sufficient stock to give him "control" of the corporation. The term "control" is the same 80% control defined in Sec. 112(h), and referred to above.

When two or more persons transfer property to a corporation, the stock or securities received by each must be substantially in proportion to his interest in the property transferred, if gain or loss is not to be recognized. For example, assume A and B form a corporation and A transfers property worth $75,000 and B transfers property worth $25,000. If A receives 75% of the stock and B receives 25%, the exchange is tax-free. But if A receives 60% of the stock and B receives 40%, the exchange is not tax-free since the stock received is not substantially in proportion to the interests of A and B in the assets transferred. The stock or securities received do not have to be exactly in proportion to the interests transferred but they must be "substantially" in proportion. The basic question is, therefore, what is "substantially in proportion".

The leading case on this point is the *United Carbon* case,* but the opinion in the *Bodell* case,** which followed the *United Carbon* case, is easier to understand. In determining whether the stock received is substantially in proportion to the property transferred, the courts apply what is called the "relative value test", which is best explained by a hypothetical example. Assume for the purpose of the example the following figures:

TRANSFERORS	VALUE OF ASSETS TRANSFERRED	VALUE OF SECURITIES RECEIVED	INCREASE OR DECREASE IN VALUE	INCREASE OR DECREASE AS PERCENTAGE OF VALUE OF ASSETS TRANSFERRED
A	$ 5,000	$6,000	$+1,000	+20%
B	4,000	5,000	+1,000	+25%
C	11,000	9,000	−2,000	−18%

* United Carbon Co. v. Commissioner, 90 F.2d 43 (C.C.A. 4th 1937).
** Bodell v. Commissioner, 154 F.2d 407 (C.C.A. 1st 1946).

In determining whether the securities received are substantially in proportion to the interests transferred, the courts look at the variance of the percentages in the last column. In this example, the percentages range from -18% to +25%; in other words, whereas one transferor has had a decrease in value of 18%, the transferor at the other extreme has had an increase of 25%. The variance of those percentages is so clearly extreme that the "substantially in proportion" test is not met and Sec. 112(b)(5) would not apply. In a situation such as that the gain or loss of each transferor (the difference between the *basis* of the property transferred and the value of the securities received) would be recognized. In the *Bodell* case the percentages ranged from -10% to -21%, and in the *United Carbon* case the spread was far greater; in both cases it was held that the "substantially in proportion" test was not met.

Under Sec. 112(b)(5), the term "securities" has the same meaning as under Sec. 112(b)(3) and Sec. 112(b)(4), discussed above. The question whether the transferor or transferors are in control of the corporation "immediately after the transfer" is the same question that arises in connection with Clause D reorganizations—the problem of step transactions—which was mentioned above. Further, in order for an exchange to come within the provisions of Sec. 112(b)(5), the transferor or transferors must receive only stock or securities in the exchange, as is true of exchanges under Sec. 112(b)(3) and Sec. 112(b)(4);* if other property or money in addition to stock or securities is received, the exchange comes within the provisions of Sec. 112(c) since the exchange is not *solely in kind*.

The last sentence of Sec. 112(b)(5) provides that, in

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* The effect of the corporation's assuming or taking property subject to the transferor's liability is covered by Sec. 112(k), discussed below at page 175.

determining whether the "substantially in proportion" test is met in cases where the transferee assumes a liability of the transferor or takes property subject to a liability, the amount of the liability shall be considered as stock or securities received by the transferor. Assume, for example, that A transfers to a corporation property worth $70,000, subject to a liability of $20,000; and that the corporation either assumes the liability or takes the property subject to the liability and issues stock to A in the amount of $50,000. Under this provision, A would be treated, for the purpose of the "substantially in proportion" test, as having received securities of a value of $70,000.

When a corporation is organized and certain individuals transfer property and others transfer cash, the courts have held that the cash comes within the meaning of the term "property" as it is used in this section. It should also be noted that the provisions of this section are very like those of Clause D of the reorganization definitions in Sec. 112(g). If a *corporation* transfers all or a part of its assets to another corporation and is immediately thereafter in control of the transferee, the transfer would be a Clause D reorganization and would also come within the provisions of Sec. 112(b)(5).

It should be kept in mind that in exchanges under Sec. 112(b)(5), as in the other tax-free exchanges under Sec. 112(b), the recognition of gain or loss is only *postponed.* Because of the basis provisions, discussed in the following chapter, the assets transferred retain in the hands of the corporation the same basis that they had in the hands of the transferors prior to the transfer; and the stock or securities received by the transferors take on the same basis that the assets transferred previously had in the transferors' hands.

Sec. 112(b)(6) (Property Received by Corporation on Complete Liquidation of Another) deals with the liquidation by a *corporation* of a subsidiary. It is never applicable to the

liquidation of a corporation owned by individuals. The section provides that, under certain rigidly prescribed circumstances, no gain or loss is recognized to a parent corporation that receives property distributed in complete liquidation of a subsidiary. Gain or loss is not recognized if *all* the following conditions are met:

1) There is a plan of complete liquidation and the parent receives the property in pursuance of the plan.

2) The parent was the owner of stock in the subsidiary possessing at least 80% of the total combined voting power of all classes of voting stock and the owner of at least 80% of the total number of shares of all other classes of stock (except non-voting preferred) at the time of the adoption of the plan and *also* during all the time intervening between the adoption of the plan and the receipt of the property.

3) The percentage of each class of stock owned by the parent (whether it was 80% or any amount between 80% and 100%) at the time of the *receipt* of the property is not *less* than the percentage owned at the date of the adoption of the plan of liquidation or at any time between that date and the date of the receipt of the property. In other words, while the parent can increase its stock holdings, it cannot dispose of any of the subsidiary's stock during the liquidation period. For example, if the subsidiary had only common stock outstanding, and the parent owned 80% at the date of the adoption of the plan, thereafter acquired an additional 10%, but then disposed of 5% so that it owned only 85% at the time of the receipt of the property, this requirement would not be met.

4) The distribution of the property by the subsidiary is in complete cancellation or redemption of all of its stock and the property is all transferred within

one taxable year; *or,* the distribution of the property is one of a *series* of distributions in complete cancellation of all of the stock and is made in accordance with a plan of liquidation under which the liquidation is to be completed within *three* years from the end of the year in which the first distribution is made.

The provisions of Sec. 112(b)(6) are an exception to the general rule with respect to distributions in liquidation of a corporation. The general rule is set out in Sec. 115(c) (discussed in Chapter 7). Under that section, when a corporation is liquidated and the stockholders receive liquidating distributions in cancellation of their stock, gain or loss is recognized but is treated as a capital gain or loss; if the liquidating distribution is greater in amount than the basis of the stockholder's shares cancelled, the difference is taxed as a capital gain while if the liquidating distribution is less than the basis of the stock, the loss is treated as a capital loss.* When, however, a subsidiary is liquidated under the provisions of Sec. 112(b)(6), the gain or loss is not recognized and the liquidation has no immediate tax effect. The reason for the non-recognition of gain or loss in the case of the liquidation of subsidiaries lies in the belief that it is wise public policy to encourage the simplification of corporate structures; under Sec. 112(b)(6) it is possible for corporations to make such simplifications without incurring immediate tax liability on any gains.

The section has no effect on the tax liability of minority stockholders. For example, assume that corporation A owned 80% of corporation B's stock and that the other 20% was owned by X. On a liquidation of B, any gain or loss realized by X would be recognized and the gain taxed or the loss allowed under the provisions of Sec. 115(c). The

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* The capital gain or loss will be long-term or short-term depending on how long the stock was held before the liquidating distribution is received.

plan for the liquidation of B might, however, be consummated by a statutory merger under which the parent corporation A received all the property of B, and the minority stockholder X received stock of A in exchange for his B stock. In that case, the receipt of the property by the parent corporation A would still come within the provisions of this section; and the exchange made by X of B stock for A stock would be within the provisions of Sec. 112(b)(3) and therefore tax-free. This type of transaction is provided for in the last sentence of Sec. 112(b)(6) and an example is given in the Regulations.

In some cases the assets of the subsidiary consist only of cash; and it has been held by one Circuit Court, in the *Tri-Lakes Steamship* case,* that a distribution consisting only of cash comes within the provisions of this section. That question cannot, however, be considered as one that is finally settled. Other difficult questions arise where the parent corporation is both a creditor and a stockholder of the subsidiary. Where the subsidiary's liability to its parent exceeds the value of its assets, then, upon a distribution of the assets of the subsidiary, the parent takes as a creditor and not as a stockholder and there is no distribution in liquidation within the terms of this section. Where, however, the subsidiary's assets exceed its liability to the parent, presumably the debt is extinguished on liquidation and all the assets are received in cancellation of the subsidiary's stock within the terms of this section; but this point also cannot yet be considered finally settled. The distinction is very important since it affects the basis of the assets in the hands of the parent.

Because of the relevant basis provisions in Sec. 113 (a)(15), recognition of the gain or loss on the liquidation of a subsidiary is, again, only postponed: the assets received by the parent have the same basis in the parent's

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* Tri-Lakes S.S. Co. v. Commissioner, 146 F.2d 970 (C.C.A. 6th 1945).

hands that they had in the hands of the subsidiary.* It is not unusual for a parent corporation to prefer to have the gain on the liquidation recognized and taxed in order to acquire a "stepped-up" basis for the assets of the subsidiary. Assume, for example, that corporation A purchased all the stock of corporation B for $100,000; and that the assets of B had a basis in B's hands of $40.000 and a fair market value of $120,000. If corporation A liquidates corporation B in a Sec. 112(b)(6) liquidation, the gain of $20.000 is not recognized or taxed to A; but the assets received by A have a basis in A's hands of only $40,000 although A has paid $100,000 for the stock. This means that A will have far lower depreciation deductions, as well as a low basis for gain or loss if the assets are later sold. If Sec. 112(b)(6) did not apply, A would have to pay a tax on the gain of $20,000 on the liquidation but would have a "stepped-up" basis of $120,000 (fair market value) for the assets. A might well prefer, in that case, to pay tax on the gain in order to obtain the higher basis.

If the subsidiary has a low basis for its assets and corporation A desires to obtain as a basis for those assets their higher, market value (at the price of paying a tax on any gain on the liquidation) A should avoid acquiring 80% or more of the stock, but should purchase, say 79%; then, upon a liquidation of the subsidiary, Sec. 112(b)(6) and the basis provisions of Sec. 113(a)(15) will not apply.** After

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* Where a parent receives the assets of a subsidiary in cancellation of the subsidiary's stock, there are two possible bases that could be used for those assets consistently with the general *theory* of Sec. 113: the basis of the assets in the hands of the subsidiary, or the parent's basis for the subsidiary's stock. Prior to the 1936 Revenue Act, the law was that the parent used the basis it had for the stock; the present provisions requiring the use of the basis the assets had in the hands of the subsidiary were enacted in the Revenue Act of 1936. See footnote to page 191.

** A corporation may, of course, also want to avoid the effect of Sec. 112(b)(6) in order to have a loss on the liquidation recognized and allowed.

a corporation has once acquired 80% or more of the stock of another corporation, it is possible but rather difficult to avoid the impact of Sec. 112(b)(6). The corporation can sell enough of the stock so that it holds less than 80%, but the sale would have to be a bona fide sale to a true third party, and not a sale to a dummy. If the sale were not bona fide and to a third party, and it was followed by a liquidation of the subsidiary, the Treasury would undoubtedly argue, and with good chance of success, that the sale was a tax avoidance device adopted only to avoid the effect of Sec. 112(b)(6) and the relevant basis provisions.

It should be remembered that Sec. 112(b)(6) applies only to a liquidation by a *corporation* of a subsidiary. It has no application to the liquidation of a corporation owned by one or more individuals, or to the liquidation of a corporation owned by a corporation and individuals if the corporation's stock ownership is less than 80%. In these latter cases, gain or loss on the liquidation is recognized and the gain taxed or the loss allowed under the provisions of Sec. 115(c); the assets received on the liquidation have a basis in the transferree's hands in the amount of their fair market value at the time of the liquidation. If, therefore, an individual purchases all of the stock of a corporation for $100,000 and the assets have a basis in the corporation's hands of $40,000 and a fair market value of $120,000, the individual does not run into the basis problems of Sec. 113(a)(15). Upon a liquidation of the corporation, he would have to pay a capital gain tax on the $20,000 gain but would have a basis for the assets received on the liquidation equal to their fair market value.

Sec. 112(b)(7) (Election as to Recognition of Gain in Certain Corporate Liquidations), Sec. 112(b)(8) (Exchanges and Distributions in Obedience to Orders of Securities and Exchange Commission), and Sec. 112(b)(9) (Loss Not Recognized on Certain Railroad Reorganizations) are not discussed.

Sec. 112(b)(10) (Gain or Loss Not Recognized on Reorganization of Corporations in Certain Receivership and Bankruptcy Proceedings) deals with the transfer of property by a corporation in receivership, foreclosure or similar proceedings or in bankruptcy proceedings under Sec. 77B or Chapter X of the Bankruptcy Act to another corporation, pursuant to court order, in order to carry out a reorganization plan approved by the court. This section provides that gain or loss is not recognized upon such a transfer if the property is transferred solely in exchange for stock or securities of the other corporation. There are two other sections related to Sec. 112(b)(10): Sec. 112(l) and Sec. 113(a)(22). The first deals with exchanges of stock or securities made by the stockholders of a corporation under a plan of reorganization described in Sec. 112(b)(10); the second contains the basis provisions applicable to the property transferred. These special sections were enacted because of the fact that creditor reorganizations do not ordinarily come within any of the reorganization definitions of Sec. 112(g). The general effect of the sections is that, when the property of an insolvent corporation is transferred to a new corporation, the transfer and the exchanges made in connection therewith are treated in essentially the same manner as they would be under the tax-free reorganization provisions. Creditor reorganizations and the many problems that they involve are not discussed in this book.

Sec. 112(c) (Gain from Exchanges Not Solely in Kind) relates to *gains* (and only to gains) from exchanges that are "not solely in kind";* this section has been referred to frequently in the earlier part of this chapter in connection with exchanges under Sec. 112(b). There are many transactions that would come within one of the provisions of Sec.

* Neither Sec. 112(c) nor Sec. 112(d), discussed below, is relevant in determining whether a transaction is a reorganization under Sec. 112(g); these Sections relate solely to the tax consequences of the particular exchanges made, assuming that there is a valid reorganization.

112(b) except for the fact that the person making the exchange receives not only the type of property that can be received tax-free but also cash or other property of a type that cannot be received tax-free. These transactions (and the transactions covered by the companion section, Sec. 112 (d), discussed below) are usually called "boot" transactions.

Sec. 112(c) covers exchanges which, if they were solely in kind, would be within the provisions of:

Sec. 112(b)(1)—property held for productive use or investment.

Sec. 112(b)(2)—stock for stock of the same corporation.

Sec. 112(b)(3)—the exchange by the stockholder in connection with a reorganization.

Sec. 112(b)(5)—the transfer of property to a controlled corporation.

If, in the exchanges listed above, the transferor receives only the type of property permitted by the pertinent section to be received tax-free, no gain or loss is recognized. If, however, the transferor receives, in addition to such property, other property or money, the exchange falls within Sec. 112(c); although no loss is recognized gain is recognized to a limited extent. The gain is recognized but *only* to the extent of the "boot"—that is, the money and the fair market value of the other property received.

Assume, for example, that, in a tax-free reorganization between corporation A and corporation B, a stockholder exchanges his old stock in corporation A and receives in exchange stock in corporation B plus a small amount of cash; assume that his A stock had a basis of $5,000 and that he receives B stock worth $7,000 and $100 in cash. His entire gain on the exchange is $2,100 but the gain is recognized only to the extent of the cash received of $100. The B stock can be received without the recognition of gain, and under Sec. 112(c) gain is recognized *only* to the extent of the money or other property received.

The general rule for determining the amount of gain recognized on boot transactions is stated in Sec. 112(c)(1). That section does not specify how the gain recognized shall be taxed. If the exchange is not made in connection with a reorganization, the gain recognized is always taxed as a gain resulting from the exchange of property. If, however, the exchange is made in connection with a reorganization, the provisions of Sec. 112(c)(2) have to be considered. Under that section, if the distribution "has the effect of the distribution of a taxable dividend", the recognized gain is taxed as an ordinary dividend to the extent of the stockholder's ratable share of the earnings and profits of the corporation; the remainder of the gain, if any, is taxed as a gain from the exchange of property. If, for example, a stockholder receives new stock and cash in exchange for his old stock in a reorganization (the exchange resulting in a gain at least as great as the cash received), the cash is taxed as a dividend to the extent of his ratable share of the earnings and profits. As a further example, suppose that, in a reorganization between A and B corporations, corporation A transfers all of its assets with the exception of some cash to corporation B in exchange for B stock; and that corporation A then liquidates and distributes the B stock and the cash to its stockholders. In that case, also, the cash received by the stockholders (if the cash represented a gain) would be taxed as a dividend to the extent of the earnings and profits. The Supreme Court has stated in the *Bedford* case * that any distribution of earnings and profits, made pursuant to a reorganization, has the effect of a distribution of a taxable dividend. But the question cannot be considered as entirely settled and there may be situations where the broad rule of the *Bedford* case would be distinguished.

Sec. 112(d) (Same—Gain of Corporation) covers exchanges which, if they were solely in kind, would be within

* Commissioner v. Estate of Bedford, 325 U.S. 283 (1945).

the provisions of Sec. 112(b)(4), that is, a transfer by a corporation of property in exchange for stock and securities in another corporation, both corporations being parties to a reorganization. If the transferor corporation receives *only* stock or securities of the other corporation, no gain or loss is recognized, under the provisions of Sec. 112(b)(4); but if the transferor receives, in addition to such stock or securities, other property or money, while no loss is recognized, gain is recognized to the extent of the "boot", *i.e.*, the money and the fair market value of the property received. Under Sec. 112(d)(2), if the corporation does not distribute the boot to its stockholders, the recognized gain is taxed to the corporation. Under Sec. 112(d)(1), if the corporation does distribute the boot to its stockholders, no gain is recognized to the corporation. When the boot is distributed, gain may be recognized to the stockholders who receive the boot; that gain would be taxed under the provisions of Sec. 112(c), either as a dividend or a capital gain depending on the nature of the distribution.

Sec. 112(e) (Loss from Exchanges Not Solely in Kind) provides that no *loss* shall be recognized in these "boot" transactions. Where no boot is received on an exchange loss is not recognized, under the provisions of Sec. 112(b). If loss like gain were recognized to the extent of the boot received, taxpayers could provide for boot in a loss transaction and thereby obtain recognition of the loss with a consequent tax deduction. The tax consequences of many exchanges would then be in the taxpayer's control: where gain was expected, the exchanges could be made without boot and an immediate tax avoided; where loss was expected, boot could be provided and an immediate deduction obtained. Because of Sec. 112(e) taxpayers cannot plan their transactions in such a way that losses will be allowed whereas gains will not be recognized.

Sec. 112(f) (Involuntary Conversions) deals with the involuntary conversion of property, as, for example, by destruction, theft, condemnation, or a threat of condemnation. Any loss on such a conversion is always recognized, but if there is a gain the gain will not be recognized (that is, subject to an immediate tax) if the requirements of this section are met. If property is converted into other property which is similar or related in service or use, the gain is not recognized. The more common situation arises, however, when property is converted into money; money received as a condemnation award would be a typical example. When money is received on an involuntary conversion, no gain is recognized if the taxpayer does any of these three things:

1) Expends the money in acquiring other property similar or related in service or use to the property converted; *
2) Expends the money in acquiring control ** of a corporation which owns such property; or
3) Puts the money into a replacement fund (under the conditions set out in the Regulations). The replacement fund would then be used at a later time to acquire either property similar to that converted, or control of a corporation owning such property.

The taxpayer must acquire the similar property, or acquire control of the corporation, or establish the replacement fund, "forthwith and in good faith". "Forthwith" does not mean immediately but it does require reasonably expeditious action. When a taxpayer is unable to acquire either similar property or control of a corporation owning similar property within a reasonable time, he can use the third alternative and establish a replacement fund which

* The question whether properties are similar or related in service or use is a question of fact; the Regulations give several examples of properties that are *not* considered similar.

** The term "control" as it is used in this section is the 80% control defined in Sec. 112(h) and discussed earlier in this chapter.

gives him a longer period of time in which to acquire directly or indirectly other similar property. He must, however, apply "forthwith" for the Commissioner's permission to establish a replacement fund, and must file a bond.

When the taxpayer acquires other property (or control of a corporation), he must be able to trace the funds received on the conversion into the purchase of the other property. It was held in the *Twinboro Corporation* case * that, if the taxpayer buys the other property out of his own funds *before* he receives the money on the conversion and then uses the conversion proceeds to replace his own funds, the section does not apply; and the Bureau has ruled ** that the section does not apply if the taxpayer uses borrowed money rather than his own funds and then repays the borrowings with the money received on the conversion.

If a part but not all of the money received on the conversion is expended in accordance with the provisions of this section, gain is recognized only to the extent of the amount not so expended. For example, if the basis of the property converted was $10,000 and the proceeds received on the conversion were $15,000, the total gain would be $5,000; if only $14,000 of the proceeds were expended in accordance with the provisions of this section, gain in the amount of $1,000 would be recognized and taxed.

Sec. 112(g) (Definition of Reorganization) has been discussed above. **Sec. 112(h) (Definition of Control)** which defines the term "control" as used in Sec. 112 has also been discussed above. **Sec. 112(i) (Foreign Corporations)** provides that, when a foreign corporation is involved, the gain on any of the exchanges under the subsections of Sec. 112 listed therein shall be recognized unless it is established to the Commissioner's satisfaction, *prior* to the exchange, that the

* Twinboro Corporation v. Commissioner, 149 F.2d 574 (C.C.A. 2d 1945).
** I.T. 3827, 1946-2 C.B. 57.

exchange is not part of a tax avoidance plan. **Sec. 112(j) (Installment Obligations)** is merely a cross-reference section.

Sec. 112(k) (Assumption of Liability Not Recognized) was added to the Code in order to nullify the effect of the Supreme Court decision in the *Hendler* case.[*] As has been explained above, when a taxpayer transfers property to a corporation solely in exchange for stock or securities, under Sec. 112(b)(4) or Sec. 112(b)(5), the exchange is entirely tax-free; but, if the transferor receives "other property or money", the exchange is only partially tax-free (under Sec. 112(c) or Sec. 112(d)) and a part of the gain is recognized. When property that is subject to liabilities is transferred to a corporation by either an individual or another corporation, in exchange for stock or securities, it is a common practice for the transferee to assume the liabilities or to take the property subject to the liabilities. In the *Hendler* case, the Supreme Court held that, in a transaction of this type, the assumption of the liabilities by the transferee was equivalent to the receipt of "other property" by the transferor; the effect was that gain was recognized to the transferor to the extent of the liabilities assumed. This doctrine would have made many ordinary business transactions impracticable and in the year following the *Hendler* decision Sec. 112(k) was added to the Code.

This section specifies that the assumption of a liability of the transferor, or the acquisition of property subject to a liability, shall not be considered as "other property or money" within the meaning of Sec. 112(c) and Sec. 112(d) and shall not prevent the transaction from being a fully tax-free exchange under the provisions of Sec. 112(b)(4) or Sec. 112(b)(5). For example, assume that a taxpayer transfers to corporation X property with a basis of $10,000,

[*] United States v. Hendler, 303 U.S. 564 (1938).

in exchange for stock of X worth $8,000, cash of $1,000, and the assumption by X of a liability of $4,000. The gain is $3,000 but it is recognized only to the extent of $1,000, the cash received; the assumption of the liability is not "other property or money" received by the transferor and therefore does not increase the amount of gain recognized.* Sec. 112(k) contains one modification of its general rule to the effect that, if there was no valid business purpose for the assumption of the liability (or the acquisition subject to the liability) or if the assumption or acquisition was part of a tax-avoidance plan, the assumption or acquisition, in the amount of the liability, will be considered as money received by the transferor on the exchange.

Sec. 112(l) (Exchanges by Security Holders in Connection with Certain Corporate Reorganizations) and Sec. 112(m) (Gain from Sale or Exchange to Effectuate Policies of Federal Communications Commission) are not discussed.

* Under the doctrine of the Hendler case, the full amount of the $3,000 gain would have been recognized since the "other property or money" received would have been $5,000.

CHAPTER 6

SECTION 113 AND SECTION 114

Sec. 113 (Adjusted Basis for Determining Gain or Loss). This section like Sec. 112, is long, detailed and rather complicated. But it is another section that is fundamental to an understanding of the Code. Sec. 113(a) sets out in twenty-two different subsections the rules for determining the "unadjusted basis" of property, which basis varies depending on the method by which the property was acquired; Sec. 113(b) then sets out the adjustments that must be made to determine the "adjusted basis". The determination of basis is necesary for two purposes: (1) for determining the amount of gain or loss on a sale, exchange or other dis-

position of property, and (2) for determining the amount that may be recovered tax-free through depreciation deductions.*

As was pointed out at the beginning of Chapter 5, the basis of property is one of the two factors that determine the amount of gain or loss on a sale, exchange or other disposition of property. The other factor is the amount realized from the sale, exchange or other disposition, as defined in Sec. 111. Sec. 113 provides the rules for determining the basis of property to be used in computing the gain or loss on a sale, exchange or other disposition of property. Sec. 114, discussed later in this chapter, provides the rules for determining the basis of property for the purpose of depreciation deductions. This latter section, however, refers back to Sec. 113 and provides that the basis for depreciation shall be the adjusted basis under Sec. 113(b) for the purpose of determining *gain* on a sale or other disposition of property. In almost all cases, the basis of property under Sec. 113 and Sec. 114 is the same. The only difference is that in two subsections of Sec. 113 two different bases are provided, one for determining gain and one for determining loss; in those particular cases, the basis under Sec. 114 for depreciation is always the Sec. 113 basis for determining *gain* rather than the basis for determining loss. This difference will be clearer when the provisions of the particular subsections are considered.

It was emphasized in the preceding chapter that, when gain or loss is not recognized on certain transactions, the recognition of the gain or loss is merely postponed to a

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* The basis of property is also a necessary factor in determining the amount of deductions for obsolescense and, sometimes, for depletion. In those cases the basis is the same as the basis for determining depreciation. Since obsolescence is a relatively infrequent deduction, and since depletion is not discussed in this book, the basis as determined under Sec. 114 (basis for depreciation, obsolescense and depletion) is referred to throughout this chapter as the basis for depreciation.

future time through the operation of the applicable basis provision. When gain or loss is not recognized on an exchange, the taxpayer does not acquire a new basis for the property he receives; the property in his hands has what is termed a "substituted basis"; this is either the basis that he had for the property he gave up in the exchange or, as in the case of property received on a tax-free liquidation of a subsidiary, the basis the transferor had for the particular property.

Returning to the Code provisions, Sec. 113 contains two main subdivisions, Sec. 113(a) and Sec. 113(b). Sec. 113(a) provides the rules for determining the "unadjusted basis"—this is the basis at the time the taxpayer first acquires the property. Sec. 113(b) then provides the rules for determining the "adjusted basis"—this is the original "unadjusted basis" after adjustments have from time to time been made. As a simple example, suppose a taxpayer buys a building for $10,000 cash; the $10 000 is the "unadjusted basis". At the end of one year, if there has been depreciation at the rate of 2%, or $200, the basis is adjusted for the depreciation and the "adjusted basis" is $9,800.

With this slight introduction, the subsections under Sec. 113(a)—unadjusted basis—can be considered in their statutory order. As has been stated before, the rules for determining the basis of property vary depending upon the method by which the property was acquired; each subsection of Sec. 113(a) provides the rule for determining the basis of property acquired in one particular way.

Sec. 113(a) (Basis (Unadjusted) of Property) states the general rule that the basis * of property is its cost unless one of the subsections of Sec. 113(a) applies. The cost of property is the amount paid for it in cash or other property.

* Here, and in the following paragraphs dealing with Sec. 113(a), the word "basis" is used, as it is in this section of the Code itself, to mean "unadjusted basis".

Thus, when property is acquired in a *taxable* exchange, the cost of the property acquired is the fair market value of the property given in exchange for it. In the usual case, the market value of the property given and the property received will be equal, and the fair market value of both properties will as a practical matter usually be determined by reference to the property whose value is most easily determinable. If that value is different from the basis of the property given up, gain or loss will be realized and recognized at the time of the exchange. If, for example, a taxpayer exchanges land with a basis of $1,000 for shares of a listed stock with a fair market value of $1,500, the stock will have a basis in his hands of $1,500 and he will be taxed on the realized gain of $500.

Property may, however, be acquired in a taxable transaction which does not involve the exchange of other property for it, as, for example, property acquired as a dividend in kind or as compensation for services; in those cases the basis of the property acquired is its fair market value at the time of its acquisition.*

One important question of basis has only recently been decided by the Supreme Court. In the *Beulah Crane* case,**

* This rule is not expressly stated in Sec. 113(a) but has long been accepted. There is one important exception to the rule in the case of stock acquired by an employee under an option received from his employer. Assume, for example, that an employee receives an option to purchase stock in the employer corporation at $50 a share at a time when the stock is selling at $60 a share, and that the option is exercised when the stock is selling at $60. The $10 that the employee saves on the purchase is taxable to him as compensation for personal services; under general basis rules the employee's "cost" basis for the stock would be $60 a share—the $50 paid in cash plus the $10 which represented compensation for services. However, under a Bureau ruling (I.T. 3795, 1946-1 C.B. 15) the $10 is part of the basis *only* if the employee reports it as taxable income. This rule is a departure from the general rule; under the general rule the basis of property received in a transaction of this kind is its fair market value at the time of receipt whether or not it was actually reported as taxable income.

** Crane v. Commissioner, 331 U. S. 1 (1947).

the Court held that when property is acquired subject to a mortgage the basis of the property is the basis of the entire property (determined under the applicable subsection of Sec. 113), and not merely the basis of the taxpayer's equity in the property. This has, of course, always been the rule when a taxpayer assumed a pre-existing mortgage on the property, but the rule where the taxpayer merely took the property subject to a mortgage had not been definitely settled prior to the *Crane* case.

Sec. 113(a)(1) (Inventory Value) refers to property included in the inventory of a taxpayer; the basis of such property is its last inventory value. This inventory value will, in many cases, not be the cost of the property since inventories are often valued at cost or market, whichever is lower. The rules for valuing inventories are contained in the Regulations under Secs. 22(c) and 22(d).

Sec. 113(a)(2) (Gifts After December 31, 1920) provides the basis of property acquired by *gift;* the general rule is that the property in the hands of the donee has the same basis it had in the hands of the donor. This section is, however, one of the two sections in which two different bases are prescribed—one for determining gain on a sale * and one for determining loss. The general rule just stated is the rule for determining gain. Assume, for example, that A purchases stock for $5,000 (his basis); and that after it has appreciated in value to $8,000 he gives it to S. The basis of the stock in the hands of S for determining gain on a later sale by S is still $5,000—the donor's basis. The reason for this rule is that the appreciation in value from $5,000 to $8,000 has never been taxed to A; if, after the gift, S were allowed a basis of $8,000 (fair market value at date of gift), the

* Throughout this chapter, as a matter of convenience, the word "sale" is frequently used to mean "sale, exchange or other disposition of property".

appreciation in value never would be taxed. Under this basis rule, if S later sells the stock for $8,000, the gain of $3,000 which was not taxed to A is realized by and taxed to S at the time of his sale.

The basis for determining *loss* on the sale of property acquired by gift is, however, different; for determining loss, the basis of the property in the hands of the donee is the donor's basis or the fair market value of the property at the time of the gift, whichever is *lower*; it should be noted that this exception comes into effect only when the fair market value of the property at the time of the gift is *less* than the donor's basis. The purpose of this special provision is to prevent taxpayers from gaining an undue tax benefit by transferring property to persons who can take advantage of tax losses. Assume, for instance, that in the example above the value of the stock at the time of the gift was $1,000. If A sold the stock he would have a capital loss of $4,000, but he might have other capital losses and no capital gains so that that $4,000 loss would be of no tax benefit to him. Except for this special provision, he might give the stock to Y who had capital gains. If Y were allowed to use the donor's basis of $5,000, Y could sell the stock, take the loss of $4,000, and thus obtain a tax benefit from the loss which the donor himself could not have obtained. For this reason, the statute provides that the donee, in determining loss on a sale, must use as his basis the fair market value of the property if that is lower than the donor's basis. In this particular example, Y would have to use $1,000 as his basis for determining loss and therefore there would be no loss on the sale.

This section applies to all outright gifts made after December 31, 1920; and, for years beginning on or after January 1, 1942, to gifts made by a transfer in trust as well as to outright gifts. The section does *not* apply to property acquired by bequest, devise or inheritance or to prop-

erty acquired by an instrument which, under Sec. 113(a)(5), is treated as though it were a will; Sec. 113(a)(5) provides the basis of such property.

Sec. 113(a)(3) (Transfers in Trust After December 31, 1920) applies only to the special case of a transfer in trust made other than by gift, bequest or devise. It originally applied to gifts made in trust but, under the amendments made by the 1942 Revenue Act, the basis of such gifts as well as the basis of outright gifts is determined under Sec. 113 (a)(2).

Sec. 113(a)(4) (Gift or Transfer in Trust Before January 1, 1921) provides the basis for gifts or transfers in trust made prior to January 1, 1921. In those early years the donee was allowed to use as his basis the fair market value of the property at the time of the gift or transfer. The law was later changed so that an appreciation in value prior to the gift or transfer in trust would not go untaxed.

Sec. 113(a)(5) (Property Transmitted at Death) states the rule for determining the basis of property acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent. The basis of the property acquired is its fair market value at the time of acquisition; and, with an exception discussed below, the time of acquisition is the date of the decedent's death. This rule is an exception to all other basis rules and is the one outstanding example in the present provisions of the Code where a "stepped-up" basis is obtained although no income tax has been paid on any intervening appreciation. If, for example, an individual owned stock in a corporation with a basis to him of $10,000 and a fair market value of $50,000 at the time of his death, his legatee or distributee (or his estate) would have a basis of $50,000 for the stock and the appreciation in value would

never become subject to income tax.* This basis rule should be compared with the rule under Sec. 113(a)(2) applicable to property given away during the owner's lifetime; in the latter case the property has the same basis (for determining gain) that it had in the hands of the donor so that any appreciation in value realized by the donee becomes subject to income tax.

This section provides that the basis to the person acquiring the property (which includes the decedent's estate) shall be the fair market value at the time of acquisition. The general rule is that the time of acquisition is the date of the decedent's death. If, however, an estate tax return is filed, the "time of acquisition" depends on the method of valuation used in the estate tax return. In that return the gross estate may be valued either as of the date of the decedent's death or as of the "optional valuation date".** The optional valuation date is the date one year after the date of death, or, if the property is sold, distributed or otherwise disposed of within one year after death, the date of such sale, distribution or other disposition. If the gross estate is valued as of the date of the decedent's death, that value fixes the basis of the property in the hands of the person acquiring the property from the decedent. If optional valuation is used in the estate tax return, that value is the basis of the property acquired.

This section applies not only to property passing from a decedent by will or by intestacy, but also to property passing under any instrument which, under this section, is treated as though it were a will. The section specifically

* The appreciation in value would be subject to estate tax if the estate were large enough to be subject to such tax. But if the individual had sold the stock prior to his death there would have been an income tax on any gain realized by the sale; and the balance of the proceeds, if not spent or lost prior to death, would also have been subject to estate tax.

** The section providing for optional valuation is Sec. 811(j) of the Code.

provides that, when a grantor has transferred property to a trust, the income of which is payable to the grantor or upon his order or direction, and has retained a power to revoke the trust at any time prior to his death, the basis of the property in the hands of the person acquiring it at the grantor's death shall be determined under this section. It is important in certain cases to determine whether the basis of property acquired by a transfer in trust is to be determined under Sec. 113(a)(2) or Sec. 113(a)(5), and in these cases the provisions of the statute and the Regulations and the case law should be carefully examined.

This section applies to property transmitted at death irrespective of whether the interest received is a present or a future interest, or is vested or contingent. The date on which the legatee, devisee or distributee comes into actual possession of the property has no relevance. For example, if the property is transferred to a testamentary trust, income to A for life and remainder to B, the basis to B as well as to the trust is the fair market value at the date of the decedent's death (or at the optional valuation date); the basis to B would, however, be subject to the adjustments set out in Sec. 113(b) for the period prior to the receipt of the property by B.

The section does not apply to property held by a surviving joint tenant or tenant by the entirety since in legal theory such survivor always owned all of the jointly held property subject only to his rights being cut off if he predeceased his co-owner; such property is not acquired by bequest, devise or inheritance. The basis of the property in the hands of the survivor is the same basis that the entire property had in the hands of both owners prior to the death of the other joint tenant or tenant by the entirety.

Sec. 113(a)(6) (Tax-Free Exchanges Generally) provides the rules for determining the basis of property received in a tax-free or partially tax-free exchange described in Secs.

112(b)-112(e), inclusive, with certain exceptions noted below. The basis of the property received is the same as the basis of the property given up on the exchange, except that the basis is (1) decreased by the amount of any *money* received by the taxpayer and (2) increased in the amount of any gain or decreased in the amount of any loss that was recognized on the exchange. As was pointed out in the discussion of Sec. 112(b) in Chapter 5, gain or loss is not recognized if the exchange is solely in kind; but through the operation of the basis provisions the recognition of the gain or loss is merely postponed. The wording of Sec. 113(a)(6) is somewhat involved because of the fact that it covers exchanges under Secs. 112(c), 112(d) and 112(e) that are *not* solely in kind, as well as the exchanges under Sec. 112(b) that are solely in kind.

If property is received on an exchange that is solely in kind, only a part of the basis rule needs to be considered: the property received on the exchange takes the basis of the property given up on the exchange. Assume, for example, that, in an exchange under Sec. 112(b)(3), a taxpayer exchanges stock in corporation A with a basis of $2,000 for stock in corporation B with a value of $3,000. The gain of $1,000 is not recognized, but under this section the basis of the B stock acquired is the same as the basis of the A stock given up on the exchange, or $2,000. If, therefore, the taxpayer later sells the B stock for any amount greater than $2,000, he realizes a gain which will be taxed at that time.

If property is received on an exchange that is *not* solely in kind, but is an exchange under Secs. 112(c) or 112(d) that is only partially tax-free, the additional provisions of the basis rule need to be considered. Assume that, in the above example, the taxpayer received, instead of just the B stock, cash of $1,200 and B stock of a value of $1,800. Under Sec. 112(c), the gain of $1,000 is recognized to the extent of the money received. The basis of the B stock under Sec. 113(a)(6) would therefore be the basis of the A stock given

up on the exchange, $2,000, decreased by the amount of money received, $1,200, and increased by the gain of $1,000 recognized on the exchange, or a net amount of $1,800. Changing the example slightly, the taxpayer might have received on the exchange "other property" worth $1,200 rather than money. The gain of $1,000 would still be recognized since gain is recognized to the extent of the money and the fair market value of other property received on the exchange. The basis of the property acquired (which includes both the B stock and the other property) would be the basis of the A stock given up on the exchange, $2,000, increased by the gain of $1,000 recognized on the exchange, or $3,000. This basis would then have to be apportioned between the B stock and the other property received. An example in the Regulations shows the method of making this apportionment.

The section also provides that, when the other party to the exchange assumes a liability of the taxpayer or takes property subject to liabilities, such assumption or acquisition shall be treated for the purpose of this section as money received on the exchange; this means only that the basis of the property received is reduced by the amount of the liabilities. The Regulations also give examples of the method of making this adjustment.

Sec. 113(a)(6) specifically does not cover property received on an exchange under certain subsections of Sec. 112(b), the basis of which is provided by Secs. 113(a)(15), 113(a)(17) and 113(a)(18). The only one of those sections that is of general importance, and the only one discussed in this book, is Sec. 113(a)(15) relating to property received by a corporation upon the complete liquidation of a subsidiary under Sec. 112 (b)(6); that basis section is discussed below. Sec. 113(a)(6) also does not cover property acquired by a corporation through the issuance of its stock or securities; the basis of such property is determined under Secs. 113(a)(7) and 113(a)(8).

Sec. 113(a)(7) (Transfers to Corporation) provides the rules for the basis of property acquired by a corporation in connection with a reorganization. Subdivision (A) relates to property acquired by a corporation in connection with certain reorganizations in taxable years beginning before January 1, 1936. This provision is not discussed since this book is dealing only with provisions that are applicable to current transactions; but it should be considered in connection with any property acquired by a corporation prior to 1936 in connection with a reorganization.

Subdivision (B) sets out the rule that applies to property acquired by a corporation in connection with a reorganization in taxable years beginning on or after January 1, 1936; the rule is that the basis of the property in the hands of the acquiring corporation is the same basis that the property had in the hands of the transferring corporation, increased by the amount of any gain and decreased by the amount of any loss recognized to the *transferring* corporation upon the transfer. If, for example, corporation A acquires all the assets of corporation B solely for voting stock in a Clause C reorganization, the basis of the assets in the hands of corporation A is the same as it was in the hands of corporation B prior to the transfer.

It should be noted that the basis provided by Sec. 113(a)(7) is not the same as the basis provided by Sec. 113(a)(6) although each of these is termed "substituted basis". Under Sec. 113(a)(6) the taxpayer carries over the basis of *his* old property to the new property; this is basis determined by reference to *other* property held by the *same* person. Under Sec. 113(a)(7) the taxpayer takes the property at the basis which it had in the hands of the former owner; this is basis determined by reference to the basis of the *same* property in the hands of *another* person. It is for this reason that under Sec. 113(a)(6) the basis is increased or decreased for gain or loss realized by the *taxpayer* on the exchange, while under Sec. 113(a)(7) the basis is adjusted for gain or loss realized by the taxpayer's *transferor*.

Sec. 113(a)(8) (Property Acquired by Issuance of Stock or as Paid-in Surplus) applies to property acquired by a corporation (1) by the issuance of its stock or securities in a Sec. 112(b)(5) transaction, or (2) as paid-in surplus or as a contribution to capital. The basis is determined in the same way as under Sec. 113(a)(7).

Sec. 113(a)(9) (Involuntary Conversion) applies to property acquired as the result of an involuntary conversion under Sec. 112(f). The basis is determined in a manner similar to that under Sec. 113(a)(6), except that the basis of the property acquired is decreased by the amount of money received *only* if the money is not expended in replacement or put in a replacement fund; as under Sec. 113(a)(6) the basis is increased by the amount of any gain and decreased by the amount of any loss recognized upon the conversion.

Sec. 113(a)(10) (Wash Sales of Stock), Sec. 113(a)(11) (Property Acquired During Affiliation), and Sec. 113(a)(12) (Basis Established by Revenue Act of 1932) are not discussed.

Sec. 113(a)(13) (Partnerships) deals, in its first sentence, with property acquired by a partnership. The basis of the property to the partnership is determined in the same way as the basis of property under Sec. 113(a)(7), that is, by reference to the basis of the property in the hands of the transferor. Thus, if a partner transfers assets with a basis of $10,000 to a partnership, the assets continue to have the same basis in the hands of the partnership. The section provides that the basis shall be increased or decreased, respectively, by any gain or loss recognized on the transfer, but, since gain or loss is not recognized on the transfer of property by a partner to a partnership, this particular provision appears academic.

The second sentence of Sec. 113(a)(13) refers to the basis of assets *distributed* by a partnership to a partner.

When a partnership distributes property to a partner in kind, no gain or loss is recognized. This rule applies not only to property received on a dissolution of a partnership, but to any property that is distributed in kind by a partnership to the partners. This section provides that the basis of the property distributed shall be such part of the basis of the partner's "partnership interest" as is properly allocable to the property distributed. A partner's "partnership interest" is, in effect, the amount of his capital investment in the partnership plus any part of his share of the partnership income (on which he has paid tax) which has not been distributed to him by the partnership. If, for example, a partner had contributed cash of $6,000 to a partnership, and is entitled to and has paid tax on $4,000 of undistributed partnership income, then the basis of his interest in the partnership would be $10,000. The part of the basis of the partnership interest properly allocable to the property distributed is determined by reference to the value of the assets at the time of the distribution rather than by reference to their basis to the partnership.*

Sec. 113(a)(14) (Property Acquired Before March 1, 1913) applies to property acquired prior to March 1, 1913, the effective date of the Revenue Act of 1913—the first income tax act subsequent to the Sixteenth Amendment. This is the second of the two sections in which two different bases are prescribed—one for determining gain and one for determining loss. The reason for the special provision of this section is that appreciation in value of property accrued prior to March 1, 1913 is not subject to tax. This section provides that, in determining *gain* on a sale, if the fair market value of the property on March 1, 1913 is greater than the basis of the property as it would otherwise be determined (after adjustments, such as those for deprecia-

* G.C.M. 20251, 1938–2 C.B. 169.

tion, etc., for the period prior to March 1, 1913), the March 1, 1913 value shall be the basis. If, for example, property was bought in 1908 for $5,000, had a fair market value on March 1, 1913 of $7,000, and was sold thereafter for $10,000, the basis for determining the gain on the sale would be $7,000 rather than $5,000; and the taxable gain would be only $3,000.

This special provision relates, however, only to *gains;* if property is sold at a loss, the general rules for determining basis apply. In the example above, if the property were sold for $4,000, the basis for determining the *loss* would be $5,000 and there would be only a $1,000 loss; this rule is obviously correct since the taxpayer has actually lost only the difference between $5,000 and $4,000. Situations can arise in which neither gain nor loss results from the sale. In the example above, if the property were sold for $6,000 there would be no taxable gain since the basis for measuring gain is $7,000; there would also be no loss for tax purposes since the basis for measuring loss is $5,000.

Sec. 113(a)(15) (Property Received by a Corporation on Complete Liquidation of Another) applies to property acquired by a parent corporation upon the complete liquidation of a subsidiary under Sec. 112(b)(6). Since gain or loss is not recognized in this type of liquidation, the parent corporation takes the property at the same basis that it had in the hands of the subsidiary prior to the liquidation.* This is the same rule that is prescribed under Sec. 113(a)(7) with respect to property acquired by a corporation in con-

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* This provision was first enacted by the 1936 Revenue Act and applied retroactively to property acquired upon the liquidation of certain subsidiaries prior to the effective date of that Act; a provision was therefore added by the 1938 Revenue Act giving those acquiring parent corporations the option of using the basis provisions in effect prior to the enactment of the 1936 Revenue Act (see footnote page 167). That, briefly stated, is the reason for the last sentence of Sec. 113(a)(15).

nection with a reorganization in which no gain or loss is recognized.

Sec. 113(a)(16) (Basis Established by Revenue Act of 1934), Sec. 113(a)(17) (Property Acquired in Connection with Exchanges and Distributions in Obedience to Certain Orders of the Securities and Exchange Commission), and Sec. 113(a)(18) (Property Received in Certain Corporate Liquidations) are not discussed.

Sec. 113(a)(19) (which has no title) provides the rules for determining the basis of stock on which non-taxable stock dividends or rights are received (called "old stock") and also the basis of the dividend stock or stock rights (called "new stock"). It applies to all "new stock" acquired in a taxable year beginning before January 1, 1936 (subparagraph (A)(i)) and to "new stock" acquired after that date if it did not constitute taxable income (subparagraph (A)(ii)). Prior to 1936 the statute specifically excluded from income all stock dividends and rights; while at the present time the Code (Sec. 115(f)) excludes from income only stock dividends and stock rights of a type that are not constitutionally income within the meaning of the Sixteenth Amendment; it is only those stock dividends and rights that are treated as "new stock" in subparagraph (A)(ii).

Under this section, the basis of the new stock and of the old stock after the distribution of the stock dividend or stock rights is determined by allocating the basis of the old stock between the old and new stock in accordance with the method of allocation set out in Sec. 29.113(a)(12)–1 and Sec. 29.22(a)–8 of the Regulations. The portion of the basis to be allocated to the old stock and to the new stock is determined by reference to the respective fair market values of the old stock and the new stock (whether stock or rights) at the time of the distribution.

Sec. 113(a)(19)

This section was added to the Code by the 1939 Revenue Act and made applicable to years beginning on or after January 1, 1939. The application of these provisions in certain types of cases would have been inequitable, as, for example, where the market value of the new stock had been reported as a taxable dividend in the earlier years. In that case, it would have been inequitable to allocate the basis of the old stock between the new stock and old stock under the provisions of this section. Subsections (B), (C), and (D) were therefore included in Sec. 113(a)(19) as special provisions covering transactions occurring in the earlier years prior to the enactment of the 1939 Revenue Act. Those subsections are not discussed.

Sec. 113(a)(20) (Property Acquired by Railroad Corporation), Sec. 113(a)(21) (Property Acquired by Street, Suburban, or Interurban Electric Railway Corporation), and Sec. 113(a)(22) (Property Acquired on Reorganization of Certain Corporations) are not discussed.

Sec. 113(b) (Adjusted Basis) provides the rules for determining the *adjusted* basis of property. As stated before, the original, or unadjusted, basis of property is determined under Sec. 113(a); it is then adjusted (either increased or decreased) for receipts, expenditures, or losses occurring after the acquisition of the property which are properly chargeable to capital account.

Sec. 113(b)(1) lists in several subsections certain adjustments that have to be made. The most common are those required by subsections (A)–(D).

(A) An adjustment for expenditures, receipts, losses or other items that affect the capital account—that is, items that do not enter the income account as either income or deduction items. This distinction between capital items and income or deduction items was discussed at the beginning

of Chapter 3. If, for example, A buys a building for $50,000 and then builds an addition at a cost of $10,000, the $10,000 is not a deductible expense but the basis of the building becomes $60,000.

(B) An adjustment for depreciation, obsolescence, amortization, and depletion for any period after February 28, 1913. The most important adjustment here is for depreciation; and the amount of the adjustment must be the depreciation "allowed but not less than the amount allowable". This rule, also, has been discussed earlier, at page 87, in connection with the deduction for depreciation. The amount "allowed" is the amount deducted on the tax return if it was not disallowed on the audit of the return. The amount "allowable" is the amount that would appear to be the proper depreciation for a particular year on the facts as they were then known. The basis of the property must be reduced by the depreciation "allowable" for each year even though no deduction was taken on the taxpayer's return and even though the deduction would not have been of any tax benefit to him. If the taxpayer deducted and was "allowed" excessive depreciation on his return, the basis must be reduced by that greater amount; again, this adjustment must be made irrespective of whether any tax benefit was gained by the excessive deduction. The Supreme Court held in the *Virginian Hotel* case * that when a taxpayer has deducted depreciation in excess of the amount allowable the basis of the property has to be reduced by the full amount of the depreciation claimed on the return (and not disallowed on audit) even though the deduction had been of no tax benefit to the taxpayer. The Court rejected the argument that depreciation is "allowed" only if it results in a tax benefit.

(C) An adjustment with respect to property acquired prior to March 1, 1913, for depreciation, obsolescence, amor-

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* **Virginian Hotel Corporation v. Helvering, 319 U.S. 523 (1943).**

tization and depletion to the extent actually *sustained* prior to that date.

(D) An adjustment in the case of stock for any distributions received with respect to the stock which were, under the law applicable to the year of the distribution, either tax-free or to be applied in reduction of basis. It is pointed out in the discussion of Sec. 115, in Chapter 7, that certain distributions on stock such as a distribution out of earnings or profits accumulated prior to March 1, 1913 are not taxable as dividends. If a taxpayer, for example, owned stock with a basis of $5,000 and received a distribution of that type in the amount of $1,000, the $1,000 would not be taxable income but would be applied to reduce the basis of the stock to $4,000.

The other adjustments set out in Sec. 113(b)(1) refer to very specialized transactions and are not discussed.

Sec. 113(b)(2) defines the term "substituted basis" which has been referred to above. When property in the hands of a taxpayer has a substituted basis, the adjustments under Sec. 113(b)(1) are not made only for the period during which the taxpayer held the particular property; if the basis of the property is determined by reference to the transferor's basis, as for example under Sec. 113(a)(7), the adjustments are first made for the period during which the same property was held by the transferor or donor or grantor; and if the basis of the property is determined by reference to the basis of other property given up in the exchange, as for example under Sec. 113(a)(6), the adjustments are first made for the period during which the other property was held by the taxpayer.

Sec. 113(b)(3) and the Regulations thereunder set out the adjustments to basis that are to be made if a corporation excludes from gross income, under the provisions of Sec. 22(b)(9), amounts of income attributable to the discharge of its indebtedness. Those adjustments have already been discussed in Chapter 2 in connection with Sec. 22(b)(9).

Sec. 113(b)(4) refers to creditor reorganizations and is not discussed.

Sec. 113(c) (Property on Which Lessee Has Made Improvements) refers to property on which a lessee has erected improvements and has already been discussed in Chapter 2, at page 42, in connection with Sec. 22(b)(11). It states, generally, that the lessor's basis shall not be increased by reason of improvements made by the lessee which improvements are excluded from the lessor's income under Sec. 22 (b)(11).

Sec. 114 (Basis for Depreciation and Depletion) provides in its first subsection (Sec. 114(a)) the rules for determining the basis of property for depreciation and obsolescence. As stated earlier, this basis is the basis as determined under Sec. 113 for the purpose of determining *gain* upon a sale or other disposition of property. With two exceptions, the basis under Sec. 114 is exactly the same as the single basis prescribed under the applicable subsection of Sec. 113(a) after the adjustments of Sec. 113(b) are made. The two exceptions are Sec. 113(a)(2) and Sec. 113(a)(14) each of which prescribe two different bases—one for determining gain and one for determining loss. In those cases, the basis under Sec. 114 for depreciation and obsolescence is the Sec. 113 basis for determining gain.

The second subsection (Sec. 114(b)) refers entirely to the basis for, and the allowance of, depletion, as in the case of mines and oil and gas wells. This section is not discussed since problems relating to depletion are of too specialized an interest to be covered in this book.

CHAPTER 7

SECTION 115 TO SECTION 125

Sec. 115 (Distributions by Corporations) deals with the method of taxing distributions made by a corporation to its stockholders. As has been pointed out in earlier chapters, an ordinary dividend received by an individual * is

* Dividends received by corporations from domestic corporations are, in effect, taxed at only 5.7%, that is, at the rate of 38% on 15% of the dividends (or at a lower rate if the corporation's net income is less than $50,000). See discussion of the dividends received credit at page 104.

taxed at ordinary income tax rates—normal tax and surtax. On the other hand, if a stockholder sells his stock, the appreciation in value (which will ordinarily be greater to the extent that the corporation has not paid out its earnings as dividends) will be taxed at only the lower capital gain rate. It is the wide variation between the rate of tax on ordinary income and the capital gain rate that makes the provisions of Sec. 115 so important.

Some corporate distributions are taxed as dividends at ordinary income tax rates. Other distributions are taxed as capital gains rather than as ordinary income since they are treated as amounts received in exchange for the stock. Still others are not taxed; either the basis of the stock is reduced, or, in the case of non-taxable stock dividends and rights, the basis of the old stock is allocated between the old stock and the new stock or rights received. Sec. 115, in its various subsections, sets out the tax treatment of the different types of corporate distributions.

Definition of Dividend. The term "dividend" as it is used in the tax law is defined in Sec. 115(a). A dividend is any distribution made by a corporation to its shareholders, whether in money or other property, out of either (1) the corporation's earnings or profits accumulated after February 28, 1913 * or (2) its earnings or profits of the taxable year (without regard to the amount of the earnings or profits at the time the particular distribution is made). Under the second clause, if a corporation has earnings or profits for the current year, a distribution at any time during the year is a dividend to the extent of the current year's earnings or profits (even though the corporation had a deficit at the beginning of the year and even though the profits were earned subsequent to the distribution).

The term "earnings or profits" is not defined in the Code,

* The importance of this date lies in the fact that March 1, 1913 is the effective date of the first income tax act subsequent to the Sixteenth Amendment.

although Sec. 115 contains several subsections setting out the effect of certain transactions on earnings or profits. Earnings or profits can be thought of, very generally, as being the same as the earned surplus of a corporation. There are, however, important differences between the two, since many transactions might be recorded differently for book purposes than for the purpose of earnings or profits. Merely as examples, the following items (among many others) might be recorded differently for book purposes than for an earnings or profits computation: (1) depreciation might, for book purposes, be computed at different rates or from a different basis than it would be computed for tax purposes; (2) the gain or loss on the sale of a corporation's assets might be computed on one basis (*i.e.*, book cost) for book purposes and on another basis (*i.e.*, adjusted basis under Sec. 113) for tax purposes; (3) distributions by a corporation of non-taxable stock dividends have no effect on earnings or profits, whereas such distributions might be treated on the books of a corporation as a reduction of earned surplus.

The effect of a particular transaction on the earnings or profits of a corporation is ordinarily determined by reference to the income tax treatment of the transaction. For example, a gain or loss that is not recognized under Sec. 112 has no effect on the earnings or profits of a corporation; if, on the other hand, gain or loss is recognized, the amount of the recognized gain or loss enters into the computation of earnings or profits. "Net income" is not, however, synonymous with "earnings or profits"; many items which do not affect net income serve to reduce earnings or profits; among these are the corporation's federal income tax and capital losses that are not allowed in determining net income. While the foregoing differences are important, for purposes of the present discussion the earnings or profits of a corporation can be thought of as the book earned surplus.

Returning to the definition of a dividend in Sec. 115(a),

distributions are taxable as dividends if they are (1) out of earnings or profits accumulated after February 28, 1913 *or* (2) out of earnings or profits of the taxable year.* Because of this second clause, it is in many cases not necessary to determine whether or not a corporation has earnings or profits accumulated after February 28, 1913 in order to determine whether or not a distribution is a dividend; if the earnings or profits of the current year equal the amount of the distribution, the distribution is taxable as a dividend.

Source of Distributions. Secs. 115(b) and 115(d) and the Regulations thereunder provide several important rules with respect to the tax treatment of corporate distributions; these rules can be summarized as follows:

(1) Every distribution is conclusively presumed to be made out of earnings or profits to the extent thereof, and out of the most recently accumulated earnings or profits (Sec. 115(b)). Thus, if there are earnings or profits of the current year, those are deemed to be paid out first. After the earnings or profits of the current year have been paid out, distributions are next deemed to be made out of earnings or profits accumulated after February 28, 1913.

(2) If there are no earnings or profits either of the current year or accumulated after February 28, 1913, distributions are deemed to be made out of earnings or profits accumulated prior to March 1, 1913, to the extent thereof. In that case, however, the distribution is not a "dividend" and is not taxed as such. The stockholder must apply the distribution in reduction of the basis of his stock, and, if the distribution is in excess of the basis, the excess is taxed as a capital gain (Secs. 115(b) and 115(d)). For example,

* The last sentence of Sec. 115(a) provides a different definition of a dividend with respect to distributions made by personal holding companies; that provision is discussed in Chapter 11 in connection with the discussion of those corporations.

if a stockholder paid $2,000 for his stock, and received a distribution of this type in the amount of $3,000, the distribution would reduce the basis of the stock to zero and the excess of $1,000 would be taxed as a capital gain.

(3) If there are no earnings or profits, either of the current year or accumulated after February 28, 1913 or accumulated prior to that date, distributions are deemed to be from other sources, such as an increase in the value of assets accrued prior to March 1, 1913, or an increase in value accrued subsequent to that date, or paid-in surplus or paid-in capital. With one exception, distributions from these sources are treated by the stockholder in the same way as the distributions under (2) above; the distribution is applied to reduce the basis of the stock and any excess is taxed as a capital gain. The exception relates to distributions out of increase in value accrued prior to March 1, 1913; in that case, the distribution is also applied to reduce the basis of the stock, but if the distribution exceeds that basis the excess is *not* taxed. Referring to the example in (2) above, a distribution of this latter type would reduce the basis of the stock to zero, but the $1,000 excess would not be subject to any tax.

It is not necessary for a distribution to be declared by the Board of Directors as a dividend in order for it to be taxed as such. And in some cases distributions are taxable as dividends even though they are not made *pro rata* to all the stockholders; if the corporation has sufficient earnings or profits, a distribution made to some of the stockholders only may be taxed as a dividend. The following are common examples of distributions that may be taxed as dividends although irregular in form. If a corporation sells property to its stockholders for an amount substantially less than its fair market value, the difference between the price paid and the fair market value of the property may be treated as a dividend. If a debtor of a corporation makes payments directly to the corporation's stockholders rather than to the

corporation, the payments will be treated as dividends. Amounts carried as loans to stockholders on the books of a corporation may be treated as dividends if there is no real expectation of repayment; in cases of this type the withdrawal by the stockholder may be treated as a dividend either in the year it was made, if there was no real intention of repayment at that time, or in a later year if the withdrawal, originally intended as a loan, is cancelled on the books of the corporation in a later year. In all these types of cases the question whether a particular distribution is in the "nature of a dividend" depends on the particular facts.

Distributions in Liquidation. Sec. 115(c) deals with distributions in liquidation, which are treated quite differently from other corporate distributions. Distributions in liquidation are treated as amounts received in exchange for the stock, that is, as though the stockholder in a sale or exchange gave up his stock and received the distribution in exchange therefor. If the amount of the distribution (cash and the fair market value of any property received) exceeds the basis of the stock, the difference is a capital gain; if the amount of the distribution is less than the basis of the stock, in some cases the difference will be a capital loss while in others the distribution will be applied to reduce the basis of the stock.*

This section applies both to distributions in complete liquidation of a corporation and to distributions in partial liquidation. There is a distribution in complete liquidation when a corporation winds up its business and distributes all its assets. Distributions in partial liquidation (as defined in Sec. 115(i)) include distributions of two different types. The first is a distribution by a corporation

* Sec. 112(b)(6) discussed above provides an exception to this general rule in the case of the liquidation of a subsidiary falling within that section.

in complete cancellation or redemption of a part of its stock. There is a distribution of this type, for example, when a corporation redeems all the shares of a particular issue, such as all its preferred shares. In this case, the stockholder has a capital gain or loss in the amount of the difference between the amount received and the basis of the stock redeemed.

The second type of distribution in partial liquidation is any one of a series of distributions in complete cancellation or redemption of all or a portion of a corporation's stock. This type of distribution includes a distribution made as one of a series of distributions (1) in complete cancellation or redemption of *all* of the stock of a corporation, or (2) in complete cancellation or redemption of all the shares of a *particular issue,* such as all of the preferred. In distributions of this type, no gain is recognized until the sum of the series of distributions received exceeds the basis of the stock; and no loss is ordinarily recognized until the final distribution is made, since the amount of the loss cannot ordinarily be determined until that time.

It is obviously to the tax advantage of a stockholder to draw out his share of the earnings of a corporation, whenever possible, in the form of liquidating dividends rather than as ordinary dividends, since he then pays a tax on any gain at only the capital gain rate. The Code, however, contains a provision (Sec. 115(g), discussed below) which blocks quite effectively most plans to save tax by distributing earnings in the form of liquidating dividends.

Stock dividends. Sec. 115(f) contains the provisions governing the taxability of stock dividends. The general rule stated in Sec. 115(f)(1) is peculiarly unenlightening since it states that a distribution in stock or rights shall not be treated as a dividend to the extent that it is not constitutionally income to the stockholder; in other words, the section states that all stock dividends are income

except those that are not income. This provision is an outgrowth of an involved legislative and judicial history.

The Revenue Act of 1916 for the first time specifically included stock dividends in gross income. In 1920, the Supreme Court held in *Eisner v. Macomber* * that a dividend paid in common stock on common stock was *not* income since the proportionate interest of each stockholder after the distribution was exactly the same as it was before and the only change effected was in the number of pieces of paper by which that interest was represented. Following that decision, the law was amended to provide that "a stock dividend shall not be subject to tax"; and the Treasury's Regulations required, in the case of any stock dividend, that the basis of the old stock be allocated between that stock and the new stock received. In 1936, the Supreme Court held, in the *Koshland* case,** that no allocation was required where a dividend in common stock had been paid on non-voting preferred since the dividend was income when received (even though specifically exempted by the statute from tax). At that point it became clear that some stock dividends could be taxed and some could not. It was also clear that the statute required immediate amendment to provide for the taxation of those dividends that were income.

Sec. 115(f) was changed in 1936 to its present form in an attempt to tax all stock dividends that could be taxed. After that amendment, the Bureau contended that all stock dividends, including those paid in common on common stock, could constitutionally be taxed and were, therefore, included within the statutory language. When the issue again reached the Supreme Court that Court held, in the *Griffiths* case, † that Congress did not *intend* by the pres-

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* 252 U.S. 189 (1920).

** Koshland v. Helvering, 298 U.S. 441 (1936).

† Helvering v. Griffiths, 318 U.S. 371 (1943).

ent section to tax all stock dividends; the Court stated that it could not, therefore, "reach the reconsideration of *Eisner v. Macomber* on the basis of the present legislation".

At the present time the controlling rule is that a stock dividend is not income if its distribution does not change the proportionate interests of the stockholders in the corporation. Under this rule, the tax status of certain distributions has been held to be as follows:

1) A dividend paid in common stock on common stock is not taxable *(Eisner v. Macomber; Griffiths).*
2) A dividend paid in common stock on preferred stock is taxable *(Koshland);* here, among other things, a part of the voting power has been shifted to the old preferred stockholders.
3) A dividend paid in new preferred stock on common stock (if there was previously no preferred stock outstanding) is not taxable (*Strassburger*)*; here, the proportionate interests of the stockholders have not changed.
4) A dividend paid in preferred stock on common stock (if there was preferred stock previously outstanding) is taxable (*Gowran* **); here, among other things, a part of the rights previously held solely by the preferred stockholders has been shifted to the common stockholders.
5) A dividend paid in non-voting common stock on voting common stock is not taxable (*Sprouse* †); here, the proportionate interests of the stockholders have not changed.

When a stock dividend or stock rights are *not* taxable, the basis of the "new stock" received and the old stock previously owned is determined under Sec. 113(a)(19), discussed in Chapter 6.

* Strassburger v. Commissioner, 318 U.S. 604 (1943).
** Helvering v. Gowran, 302 U.S. 238 (1937).
† Helvering v. Sprouse, 318 U.S. 604 (1943).

Sec. 115(f)(2) provides that when a distribution is payable at the election of the stockholders either (1) in stock or rights of a type that would be non-taxable or (2) in money or other property (including stock or rights of a type that would be taxable) the distribution is to be treated as a taxable dividend, irrespective of which election is made. This is an example of the doctrine of constructive receipt. Since the stockholder can, by his own election, receive money or other taxable property, the distribution is taxed as though it were made in money or other property even though the taxpayer elects to receive the distribution in what would normally be a non-taxable form. It is the stockholder's *right* to receive money or other property that makes the distribution a taxable one.

Distributions Equivalent to Taxable Dividends. It was pointed out above that a stockholder obtains a substantial tax advantage if he can draw out his share of the earnings of a corporation as liquidating dividends rather than receiving them as ordinary dividends, since he then pays tax at only the lower capital gain rate. Sec. 115(g) contains the provisions aimed at preventing this type of tax-avoidance. The section provides that, if a corporation cancels or redeems its stock at such a time and in such a manner as to make the distribution and cancellation or redemption (in whole or in part) essentially equivalent to the distribution of a taxable dividend, the distribution is to be treated as a taxable dividend (to the extent of the earnings or profits of the corporation).

To take an extreme example, assume that A owns all the stock of corporation B, with a basis for the stock of $10,000; and that corporation B has capital of $10,000 and earnings or profits of $40,000. A might decide to turn in half his stock (basis of $5,000) and receive in cancellation of the stock an amount equal to half the corporation's capital and earned surplus, amounting to $25,000, in the

hope that the gain of $20,000 would be treated as a distribution in partial liquidation and taxed as a capital gain. Sec. 115(g) would clearly apply since the distribution of the $25,000 is "essentially equivalent to the distribution of a taxable dividend". After the cancellation of half the stock A would still own the entire corporation and the corporation would continue in business; the effect on both A and the corporation would be just the same as though a dividend of $25,000 had been declared and paid.

Sec. 115(g) will also ordinarily apply, even when there are a number of stockholders, if a corporation cancels or redeems a part of its stock *pro rata* among all its stockholders, since after such a distribution each stockholder still has the same proportionate interest in the corporation that he had before the cancellation or redemption. The fact that a corporation does not retire the stock but holds it as treasury stock has been held, in the *Kirschenbaum* case,* not to prevent the application of this section.

There are, of course, many distributions in cancellation of stock to which this section does not apply. If there are several, or many, stockholders, and the corporation cancels or redeems all the stock of one particular stockholder, this section does not apply; the effect of that transaction is not the same as the distribution of a taxable dividend since the particular stockholder whose stock is cancelled ceases to have any further interest in the affairs of the corporation. In some cases that have been litigated the courts have held that a particular cancellation or redemption by a corporation of a part of its stock, or the retirement of a particular issue, did not come within the provisions of this section because the facts showed that there was a good business reason for reducing a capital structure that had become unnecessarily large for the conduct of the corporation's business. According to the Regulations, however,

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* Kirschenbaum v. Commissioner, 155 F.2d 23 (C.C.A. 2d 1946).

any distribution in cancellation or redemption of a corporation's stock other than a distribution in cancellation of all of the stock of a particular stockholder or a distribution or distributions in cancellation of all of the stock of the corporation may be equivalent to the distribution of a taxable dividend, depending on the particular circumstances of each case.

Effect of Distributions on Earnings and Profits. Secs. 115(h), 115(l) and 115(m) all deal with the effect of certain transactions on the earnings or profits of a corporation; these sections are not discussed since their provisions are far too technical to be covered in this book. The general rule contained in Sec. 115(h) is that a distribution by a corporation has no effect on its earnings or profits if the distribution is of a type with respect to which gain is not recognized to the distributee, or if the distribution is of a type which is not constitutionally income to the distributee.

One other rule that is set out in the Regulations (Sec. 29.115-11) should be mentioned; this is known as the "Sansome rule" from the case * of that name. The rule is, briefly, that in a tax-free reorganization or liquidation the earnings or profits of the transferor corporation (or the proper proportionate part thereof) are carried over to and become a part of the earnings or profits of the transferee corporation. As a simple example, assume that a parent company P has no earnings or profits, while its subsidiary S has earnings or profits of $100,000; and that P acquires the assets of S in a tax-free liquidation under Sec. 112(b)(6). Under the *Sansome* rule, the earnings or profits of S become earnings or profits of P, with the result that if P later makes a distribution to its stockholders the distribution will be out of earnings or profits and so taxable as a dividend. This rule has recently been extended to apply to a

* Commissioner v. Sansome, 60 F.2d 931 (C.C.A. 2d 1932).

deficit of a transferor in a tax-free reorganization or liquidation; a deficit in earnings and profits is also carried over and reduces the earnings and profits of the transferee corporation.

Dividends in Kind. Sec. 115(j) provides that, if a dividend is paid in property rather than in money, the amount to be included in income by the stockholder is the fair market value of the property at the time the dividend becomes income. If, for example, corporation A paid a dividend in the stock of corporation B, the stockholders of corporation A would report as a dividend the value of the B stock at the time they received it as a dividend.

A number of questions can arise when a corporation distributes as a dividend property that has appreciated in value in the hands of the corporation. Assume, for example, that corporation A purchased stock of corporation B for $20,000 and distributed the B stock to its stockholders at a time when it had appreciated in value to $30,000. The first question is whether corporation A realizes a gain in the amount of $10,000 on the distribution of the appreciated property (as it would if it had sold the property and then distributed the proceeds to its stockholders). Since the Supreme Court's decision in the *General Utilities & Operating* case,* the Tax Court and the Circuit Courts have consistently held that a corporation does not realize gain by distributing in kind assets that have appreciated in value.** The Bureau has, however, always contended that the *General Utilities* case did not constitute a holding on that point † and continues to litigate the question.

* General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

** The situation considered here is where the dividend resolution provides for the payment of a dividend in kind. If the resolution provides for a dividend payable in cash, and property is later distributed in satisfaction of the dividend obligation, gain is realized by the corporation.

† In the General Utilities case, the company declared a dividend of

The second question is whether the distribution of the appreciated property increases the earnings or profits of the corporation by the amount of the appreciation. Again, the courts have generally * held that the distribution does not effect an increase in the earnings or profits. The Bureau is, however, still contending that such a distribution does increase the earnings or profits to the extent of the appreciation; and has continued to litigate the issue, although unsuccessfully, in many cases.

The third question relates to the amount of the distribution that is taxable to the stockholders as a dividend. The distribution can be taxed as a dividend, of course, only to the extent of the earnings or profits of the corporation. Assume that, in the example above, the corporation had earnings or profits of $25,000 (which does *not* include the appreciation of $10,000 in the value of the B stock). The distribution of the B stock at a time when it was worth $30,000 would be a taxable dividend to the extent of the earnings or profits of $25,000. Under the rule stated in the paragraph above the distribution would *not* increase the

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$1,071,426 "payable in common stock of the Islands Edison Company". The Commissioner argued before the Board that the dividend was a cash dividend satisfied by delivery of the stock. Not until the oral argument in the Supreme Court did the Commissioner contend that even if the dividend was a dividend in kind the corporation nevertheless realized a gain by the distribution. The Supreme Court held that the Board "rightfully decided that petitioner derived no taxable gain" from the distribution, stating: "This was no sale; assets were not used to discharge indebtedness". The Tax Court considers this a holding that a corporation does not realize gain by a distribution of appreciated assets as a dividend in kind; the Bureau still contends that the General Utilities decision turned on procedural grounds and continues to litigate the issue.

* A distinction was drawn in Commissioner v. Wakefield, 139 F.2d 280 (C.C.A. 6th 1943), which case has been followed in a few other cases; in that case the court held that the earnings or profits were increased by the amount of the appreciation on the ground that the property had originally been purchased out of earnings or profits.

earnings or profits of the corporation, so that the distribution would not be a taxable dividend to any greater extent than $25,000. It is immaterial that the B stock had a basis in the corporation's hands of only $20,000. 1

Sec. 116 (Exclusions From Gross Income) lists several items which, in addition to those contained in Sec. 22(b), are not included in gross income and are exempt from tax. The only item of general importance which is excluded by this section is that contained in Sec. 116(a); and the provisions of that section are the only ones that are discussed.

Under the general rule of the tax law any *citizen* of the United States, irrespective of his residence, and any *resident* of the United States, irrespective of his citizenship, must include in gross income all his income items whether they are from United States sources or from foreign sources. Sec. 116(a) provides one exception to this rule, which is applicable to individual citizens only and not to alien residents.

Sec. 116(a)(1) provides that an individual citizen can exclude from his gross income amounts received as compensation for personal services performed outside the United States * if he is a bona fide resident of a foreign country or countries during the *entire* taxable year. The essential requirement under this section is that the taxpayer must be a bona fide resident of a foreign country or countries. The rules for determining his residence are the same as those that are applied (under Sec. 211 and the Regulations thereunder, discussed in Chapter 9) in determinating whether an alien is a resident or a nonresident of the United States. In general, the citizen would be a resident of a foreign country (1) if he went there to live without having any definite intention as to the length of

* Except amounts paid by the United States or an agency thereof.

his stay, or (2) if he went there for a definite purpose which by its nature might require an extended stay, and so actually made his home there, although he intended to return to this country at the end of the period. On the other hand, a person who goes to a foreign country for a definite purpose which will not require an extended stay will not be considered a resident of the foreign country.

When a bona fide foreign residence is established and exists throughout the entire taxable year, the individual can exclude from income *only* compensation for personal services performed in the foreign country—all other income, such as dividends and interest, remains subject to United States tax. Further, since the foreign earned income is not subject to tax, the individual cannot take any deductions allocable to that income.

Sec. 116(a)(2) states the rules applicable to income that is received after a citizen, who has been a bona fide resident of a foreign country in previous years, has returned and become a resident again of the United States. If he has been a bona fide resident of a foreign country or countries for at least two years prior to his return, any amounts received after his return as compensation for personal services previously performed outside the United States are excluded from income. For example, assume that a United States citizen was a bona fide resident of England during 1946 and 1947 and returned to this country in 1948. Any income from personal services performed in England in 1946 and 1947 which is received in 1948 or in later years is exempt from United States tax, and the fact that payment is not received until after the taxpayer's return to this country makes no difference.

It should be noted, however, that Sec. 116(a)(2) refers only to the year of return to the United States (or later years). In the year during which an individual *leaves* this country and establishes a foreign residence the exclusion

does not apply since he was not a foreign resident during all of that year.

Sec. 117 (Capital Gains and Losses) contains the provisions relating to capital gains and losses. It has been emphasized throughout this book that the distinction between capital gains and ordinary income is extremely important because of the great difference in the applicable tax rates. Back in the 1920s when the variance between the two rates was not so great the distinction was of much less importance. During the years 1925 to 1931, for example, the highest rate of tax on the ordinary income of individuals was only 25% and the capital gain rate was 12½%. At the present time, the highest rate of tax on the ordinary income of individuals has increased to 82% while the maximum capital gain rate has increased to only 25%. The 25% maximum capital gain rate applies to the gain on the sale or exchange of certain assets only if they have been held for more than six months, that is, to long-term capital gains. If the assets have been held for six months or less any gain is a short-term gain and is taxable at ordinary income tax rates. Although it is not technically correct, the terms "capital gains" and "capital losses" are used in many places in the text, as in ordinary speech, to mean long-term capital gains and losses. In this chapter, whenever it is necessary to make a distinction between long-term and short-term capital gains and losses, the exact terms are used.

Ever since 1921 capital gains have been subject to a lower rate of tax than ordinary income. The basic theoretical reason for this lower rate is that the appreciation in value of capital assets has, in many cases, accrued over a period of years; but when the assets are sold, the gain is realized and subjected to tax all in one year. Because of

the progressive tax rates, the tax (if the gain were taxed as ordinary income) would be greater than it would be if the gain were spread over the period in which the appreciation in value took place. The lower rate of tax applicable to long-term capital gains represents a rule-of-thumb measure intended to offset to some extent the tax disadvantage arising from the fact that the entire gain is realized and taxed in one year. Since 1942, capital gains have been allowed the lower rate of tax if the assets have been held for more than six months—the gains are then long-term gains. This is the shortest period that has ever been used as the breaking point between long-term and short-term capital gains and losses.

The exact tax treatment of long-term and short-term capital gains and losses is set out more fully below, beginning at page 223. In *general,* however, the following rules apply:

1) A short-term gain of an individual or corporation receives no benefit from the capital gain provisions; it is taxed at the same rates as ordinary income.

2) A long-term gain of an individual is taken into income at only 50% of the actual gain; the tax cannot, therefore, be more than one-half the tax on ordinary income in the taxpayer's particular bracket; and the tax is limited to 25% of the *actual* gain. A long-term gain of a corporation is taken into income in full; and the tax is limited to 25% of the gain.

3) Neither a short-term nor a long-term loss can be deducted from ordinary income, except that individuals are allowed to deduct losses to the extent of $1,000. Capital losses (with the above exception) can be used only to offset capital gains and can be carried over for a period of five years to offset capital gains in those later years.

The rules above are given in very general form merely to make the following discussion (which precedes the discussion of the exact tax treatment of capital gains and losses) a little clearer.

It must be kept in mind, in considering Sec. 117, that the special tax treatment of gain and loss there provided is applicable only to certain specified kinds of property *and,* in general, only if there is a sale or exchange of the property.* The difficult problem relates to the character of the property involved; that problem is discussed below, beginning at page 216. The requirement of a sale or exchange cannot be ignored, however. If, for example, a taxpayer buys a mortgage bond of an individual and merely holds the bond and receives the principal amount when due, any gain realized is an ordinary gain even though the bond is a capital asset since there has been no sale or exchange of the asset. There are several types of transactions which, though not literally either sales or exchanges, are treated under special provisions of the Code as though they were sales or exchanges. An example is the retirement of certain corporate bonds under the provisions of Sec. 117(f); other examples are listed on page 226.

One other point to remember concerns the deductibility of losses by individuals. Losses are allowed as deductions to individuals only if they come within one of the three classes of losses allowed by Sec. 23(e) (discussed in Chapter 3). Sec. 117 does not provide for the deduction of any additional losses; it merely determines whether a loss of an individual that is allowable under Sec. 23(e) is to be treated as a capital loss or as an ordinary loss. For example, if an individual sells his personal residence at a gain, the gain is taxable; and under the provisions of Sec. 117 it is taxable as a capital gain. But if the sale results in a loss, the loss

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* Throughout the balance of this chapter, as a matter of convenience, the word "sale" is frequently used to mean "sale or exchange".

is not deductible because it is not one of the types of losses allowed by Sec. 23(e); in that case, therefore, Sec. 117 has no applicability because the loss is not an allowable loss.

Capital Gain or Loss v. Ordinary Income or Loss. The special tax treatment provided by Sec. 117 applies only to gain or loss realized on the sale or exchange of capital assets (as defined in Sec. 117(a)(1)) and to gain or loss which, under special statutory provisions, is treated as gain or loss from the sale or exchange of capital assets. The definition of capital assets is contained in Sec. 117(a)(1), but that section should be read in conjunction with Sec. 117(j) which contains important rules with respect to the treatment of gains and losses on the sale of certain types of business property.*

Under Sec. 117(a)(1), the term "capital assets" means *all property* held by the taxpayer, whether or not connected with his trade or business, *except* the following:

1) Stock in trade or other property of a kind that would properly be included in the inventory;
2) Property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business;
3) Depreciable property used in the trade or business;

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* Prior to the 1942 Revenue Act, the term "capital assets" under Sec. 117(a)(1) did *not* include depreciable property used in the trade or business, but *did* include land used in the trade or business. Whenever improved real estate used in the trade or business was sold, it was necessary to allocate a part of the gain or loss to the land and a part to the building since the tax treatment of the two was different. The statute was amended by the 1942 Revenue Act to provide uniform treatment of gains and losses on the sale of land and buildings used in a trade or business. The amendment was made by excluding both types of property from the coverage of Sec. 117(a)(1) and placing them within the coverage of a new section (Sec. 117(j)) which provided special, favorable treatment for assets used in a trade or business.

4) Real property used in the trade or business;

5) Certain short-term government obligations issued on or after March 1, 1941 on a discount basis.

If the taxpayer sells any property other than property of one of the five types listed above, he realizes *capital* gain or *capital* loss. If he sells property of one of the five types of property listed above, he realizes *ordinary* gain or *ordinary* loss *except* in the very important cases covered by Sec. 117(j).

Sec. 117(a)(1) excludes from the definition of capital assets both depreciable property and real property used in the taxpayer's trade or business. However, Sec. 117(j) provides, in effect, that, on sales or exchanges of such property (held for more than six months), if the gains exceed the losses the net gain shall be considered as a capital gain but that if the losses exceed the gains the losses and gains are ordinary losses and gains.* The provisions of Sec. 117(j) (as they apply to sales and exchanges) are discussed below in more detail.

Sec. 117(j)(1) first defines, for the purposes of that section, the term "property used in the trade or business" as including:

a) Depreciable property used in the trade or business and held for more than six months; and

b) Real property used in the trade or business and held for more than six months;

and as *not* including:

c) Property which would properly be included in the inventory; and

* Sec. 117(j) also covers involuntary conversions of property used in the trade or business and capital assets held for more than six months. Since involuntary conversions are of limited interest, the discussion in the text is confined to sales and exchanges; the principles stated are, however, equally applicable to cases of involuntary conversion. Sec. 117(j) also applies to gains or losses from the cutting of timber under the provisions of Sec. 117 (k); the latter section is not discussed and is ignored in the discussion of Sec. 117(j).

d) Property held primarily for sale to customers in the ordinary course of trade or business.

This definition of "property used in the trade or business" is included in Sec. 117(j) solely for convenience of reference so that the term "property used in the trade or business" can be used to include (a) and (b) above and to exclude (c) and (d).

Under Sec. 117(j)(2) all the recognized gains and losses during the taxable year from sales or exchanges of property used in the trade or business are aggregated. If the gains exceed the losses the net gain is considered as a long-term capital gain. If the losses exceed the gains, the net loss is an ordinary loss and deductible in full against ordinary income. This section operates always to the taxpayer's advantage since a net *gain* is taxed at the lower capital gain rate while a net *loss* is an ordinary loss.

When Sec. 117(a)(1) is considered together with Sec. 117 (j) the tax status of the five types of items listed on page 216 above is as follows:

1) Stock in trade or other property of a kind that would properly be included in the inventory: gain or loss is ordinary gain or loss. Sec. 117(j) does not apply.

2) Property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business: gain or loss is ordinary gain or loss. Sec. 117(j) does not apply.

3) and 4) Depreciable property and real property used in the trade or business:

A) Held for six months or less: gain or loss is ordinary gain or loss.

B) Held for more than six months: if the gains exceed the losses the excess is taxed as a long-term capital gain under Sec. 117(j); if the losses exceed the gains the excess is an ordinary loss.

5) Certain short-term government obligations is-

sued on or after March 1, 1941 on a discount basis: gain or loss is ordinary gain or loss. Sec. 117(j) does not apply.

The two sections, Sec. 117(a)(1) and Sec. 117(j), are not particularly difficult to handle once it is remembered that Sec. 117(j) relates to sales or exchanges only of depreciable property and real property used in the trade or business and held for more than six months; all other sales or exchanges of property still come within the provisions of Sec. 117(a).

In determining whether the capital gain and loss provisions apply, there is little difficulty with respect to property under headings (1) and (5) above. The questions that arise usually concern property under heading (2) (property held primarily for sale to customers in the ordinary course of business) and property under headings (3) and (4) (depreciable property and real property used in a trade or business). These questions are:

1) Is the property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. If it is, any gain or loss is an ordinary gain or loss, taxable in full at ordinary income tax rates or allowed in full as a deduction, under Sec. 117(a)(1).

2) Is the property depreciable property or land used in the trade or business and held for more than six months (but not held primarily for sale to customers in the ordinary course of trade or business). If it is, any net gain is taxable as a capital gain under Sec. 117(j) and any net loss is an ordinary loss.

3) Is the property held merely for personal use or for the production of income (and not held for sale to customers and not depreciable property or land used in a trade or business). In that case, the property is a capital asset under Sec. 117(a)(1); any gain is a capital gain, and any loss (if it is an allowable loss under Sec. 23(e)) is a capital loss.

There are a great many cases involving the foregoing questions. The following resume of the tax effects of sales of real estate, in different situations, is given merely to point out the controlling principles. These questions arise very frequently in connection with such sales and the principles involved are of general application.

A "dealer", that is, a person engaged in the business of buying and selling real estate, of course holds property primarily for sale to customers in the ordinary course of his business. A taxpayer who holds real estate to obtain rental income or in the expectation of a future appreciation in value does not hold the property primarily for sale in the ordinary course of his trade or business; the property is either property used in his trade or business of renting or property held as an investment. A taxpayer who rents or speculates in real estate does, however, often both buy and sell real estate and it is often a close question whether such a taxpayer is in the business of buying and selling real estate. The answer to that question depends on many factors but two of the most important are: (1) the amount of the taxpayer's activities in connection with the sales and (2) the frequency and continuity of the sales. For example, a taxpayer who purchases a piece of land and subdivides it and then sells the subdivided lots will ordinarily be considered as holding the property primarily for sale to customers in the ordinary course of a business. But if a taxpayer holds real estate (as, for example, unimproved property) in the expectation that there will be an appreciation in value so that he can later sell it at a gain, the property is held as in investment. And if a taxpayer holds one or several pieces of real estate from which he collects rental income, making only occasional sales, the property will ordinarily be considered property used in the trade or business of renting and not property held primarily for sale.

If property is not held primarily for sale, it is important to determine in the case of *losses* whether the property is

used in a trade or business. The problem arises because of the fact that Sec. 117(j) applies only to depreciable property and land used in a trade or business. Property held merely for the production of income, but not used in a trade or business, is a capital asset under Sec. 117(a) and any loss on the sale of such property is a capital loss. The Commissioner had contended for a long time that, when a taxpayer owns just one piece of property that is rented, the property is not property used in a trade or business; on the other hand, the courts have held that this one piece of rented property is property used in the taxpayer's business of renting property. The Commissioner has now acquiesced in the Tax Court's decision in the *Hazard* case * which held that one piece of rented property is property used in a trade or business; the effect is that any loss on a sale of such property is treated as an ordinary loss. (It has been settled for a long time, of course, that a taxpayer can be engaged in more than one business.)

If property is not held primarily for sale in the ordinary course of business, and is not property used in the trade or business, it is either property held for the production of income (though not used in a trade or business) or property held for purely personal use. In either case, any gain on a sale will be a capital gain under the provisions of Sec. 117(a)(1); but a loss on a sale will be allowed under Sec. 23(e) *only* if the loss is incurred in a transaction entered into for profit. The loss, if allowed, is a capital loss. If, for example, a taxpayer sells his personal residence, any gain is a capital gain but no loss is allowed.** If a taxpayer

* Leland Hazard, 7 T.C. 372 (1946).

** If the residence had been rented prior to the sale, any loss on the sale would, under the Hazard and other cases, be a loss on the sale of property used in a trade or business. It has also been held that when a taxpayer has inherited residential property, which he himself has not used as a residence, and which has been listed for rental, a loss on the sale of the property is allowable as a loss sustained in a transaction entered into

holds property, such as unimproved real estate, for the production of income, *i.e.*, a realization of future appreciation in value, the property is held as an investment; in this case any loss on a sale would be allowable and would be a capital loss.

The provisions of Sec. 117(a)(1) define capital assets to include all "property" except that specified, but questions arise whether certain items are "property" within the meaning of that definition. A right to income, such as a right to salary or to dividends or rental payments, is not property within the meaning of Sec. 117; if the right is assigned to a third person, the transaction is not a sale of a capital asset and the amounts received on the sale are taxable as ordinary income. This is because the amounts received on the assignment of the right are a substitute for the salary or dividend or rental payments which, if received directly, would have been ordinary income. A life interest in a trust has, however, been held a capital asset on the sale of which there is a capital gain or loss measured by the difference between the proceeds of sale and the value of the interest sold. A partner's interest in a partnership is a capital asset and if the interest is sold any gain or loss is taxed as a capital gain or loss. In the case, however, of a personal service partnership such as a law firm, amounts received by a withdrawing partner may be treated as ordinary income since they may represent a share of partnership income rather than the proceeds of the sale of a capital asset. This question of partnership interests is discussed further in Chapter 9 in connection with the general discussion of partnerships. The question has also recently arisen concerning the tax status of the gain or loss when a sole proprietor sells an entire business. The Second Circuit Court has held in *Williams v. McGowan* * that such a sale

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for profit even though the property was not actually rented prior to the sale.

* 152 F.2d 570 (C.C.A. 2d 1945).

is a sale of the separate assets of the business—such as the inventory, accounts receivable, and fixtures—and is not a sale of the business as an entity. The sale of the business is, therefore, not a sale of a capital asset; it must be determined with respect to each asset of the business sold whether or not the asset is a capital asset.

Particular questions involving capital gains and losses also arise in connection with transactions of mortgagors and mortgagees; these are discussed below in a separate section of this chapter. One other problem of very current interest—that arising out of the *Court Holding* case *—is also discussed in a later section of this chapter.

Tax Treatment of Capital Gains and Capital Losses. After it is once determined that a gain or loss is a capital gain or loss, the tax computation is not particularly difficult even though the provisions cover three pages of the Code—Secs. 117(a)(2)–117(a)(11), and Secs. 117(b)–117(e).

Secs. 117(a)(2)–117(a)(11) list the various definitions. A short-term capital gain or loss results from the sale of a capital asset held for six months or less. A long-term capital gain or loss results from the sale of a capital asset held for more than six months. In the case of taxpayers other than corporations ** only 50% of the long-term gain or loss is taken into account (Sec. 117(b)) and for those taxpayers it is this gain or loss, after the reduction by 50%, that is defined as the long-term gain or loss.

Short-term gains and losses are aggregated and the net figure is either a "net short-term gain" or a "net short-term loss". Long-term gains and losses are also aggregated and a net long-term gain or net long-term loss determined. The

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* Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

** For convenience, this entire group, which includes trusts and estates as well as individuals, is hereinafter referred to as "individuals".

term "net capital gain" means, in general,* the excess of all gains over all losses (to the extent taken into account) irrespective of whether they are long-term or short-term; and "net capital loss" means, in general, the excess of the losses over the gains.

Neither net short-term losses nor net long-term losses can be deducted from ordinary income (except for the deduction to the extent of $1,000 allowed to individuals). These capital losses can be used only to offset capital gains. However, a net short-term loss can be used to offset a net long-term gain; and a net long-term loss can be used to offset a net short-term gain.

If a taxpayer has a net short-term gain (in excess of any net long-term loss), the excess of the gain is included in income and taxed at ordinary income tax rates. If the taxpayer has a net long-term gain (in excess of any net short-term loss) the excess of the gain is also included in income and taxed at either ordinary income tax rates or at the alternative tax rate (Sec. 117(c)) of 25% of the *actual* gain, whichever tax is less. The alternative rate of tax on the net long-term gain (in excess of any net short-term loss) of individuals is stated in Sec. 117(c)(2) as 50%. Since, however, only 50% of the long-term capital gains and losses of individuals are taken into account, the alternative tax rate is actually 25% of the gain—that is, 50% of 50%. The reason the Code provisions are stated in these terms is that not all taxpayers pay tax on long-term capital gains at the alternative tax rate; for taxpayers in the lower surtax brackets, the tax is less if the gains are taxed at ordinary income tax rates. If long-term gains were taken into account in full and the alternative tax rate were 25%, the lower bracket taxpayers would obtain little or no benefit

* The definitions of "net capital gain" and "net capital loss" in Secs. 117(a)(10) and 117(a)(11) are somewhat complicated because of the fact that they take into account the $1,000 loss allowed to individuals as a deduction and the capital loss carry-over allowed by Sec. 117(e).

from the reduced capital gain rate. Under the Code provisions a taxpayer, for example, who has taxable ordinary income of $5,000 and long-term capital gains of $1,000 would include $500 of the gains in income and pay a tax on them of $114.40, or at a rate of 11.44% on the full amount of the gains. The alternative tax rate on long-term gains results in a lower tax only for individuals whose tax rate in the highest bracket is over 50%. For corporations, the full amount of the gains is taken into account, and the alternative tax rate is therefore 25%.

As stated above, net capital losses cannot, with one exception, be deducted from ordinary income. The exception is contained in Sec. 117(d) which allows taxpayers other than corporations to deduct net capital losses to the extent of $1,000 (or to the extent of the taxpayer's net income if it is less than $1,000). The net capital losses can, however, (under Sec. 117(e)) be carried over, by both corporations and individuals, for a period of five years to offset net capital gains in those years. When an individual carries over a net capital loss to a later year, that loss together with any net capital losses of the later year can be applied to offset ordinary income to the extent of $1,000.

Retirement of Bonds. Sec. 117(f) provides that amounts received by the holder upon the retirement of certain bonds and other evidences of indebtedness shall be treated as amounts received in exchange therefor; the effect is that any gain or loss on the retirement is a capital gain or loss. This section applies only (1) to the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by a *corporation* (including those issued by a governmental body) and (2) only if the bonds, etc., or other evidences of indebtedness are in registered form or have interest coupons attached. If, for example, the mortgage bond of an individual, or a corporate note not in regis-

tered form and without interest coupons, is retired, any gain or loss is not within the provisions of this section.

Other Transactions Treated as Sales or Exchanges. Sec. 117(f) is only one out of several sections of the Code in which it is provided that a transaction which is not literally a sale or exchange shall be treated as though it were. Other sections of the Code where it is provided that certain transactions shall be treated as sales or exchanges have been referred to in earlier parts of the book. These are:

Sec. 23(g)—stock and rights which become worthless—loss treated as a capital loss (see page 77).

Sec. 23(k)(2)—debts which are evidenced by securities and which become worthless—loss treated as a capital loss (see page 82).

Sec. 23(k)(4)—non-business bad debts—loss treated as a short-term capital loss (see page 82).

Sec. 115(c)—amounts distributed in complete or partial liquidation of a corporation—gain or loss treated as a capital gain or loss (see page 202).

Sec. 115(d)—certain corporate distributions—any excess over the basis of the stock treated as a capital gain (see page 200).

Short Sales and Options. Sec. 117(g) provides that gains or losses from short sales shall be considered as capital gains or losses. When a short sale is made there is no gain or loss at the time of the sale itself since there is not at that time a closed transaction. Gain or loss is determined at the time the taxpayer delivers stock to replace the borrowed stock, and thereby completes the transaction. Whether the gain or loss is short-term or long-term depends on the holding period of the stock delivered to replace the borrowed stock.

This section also provides that gains or losses attributable to the failure to exercise options to buy or sell prop-

erty ("calls" or "puts" if the property consists of securities) shall be considered as short-term capital gains or losses. If, for example, a taxpayer sells a put or a call and the option is not exercised, the amount received by the taxpayer on the sale is a short-term gain; the amount paid by the purchaser of the option is a short-term loss.

Determination of Holding Period. Sec. 117(h) sets out the rules that are applicable in certain special situations in determining the period during which an asset has been held. The holding period determines whether a capital gain or loss is short-term or long-term. These rules are not discussed in detail but are summarized below:

Sec. 117(h)(1). If the property has a substituted basis determined by reference to other property held by the taxpayer which was given in exchange for the present property (the type of basis under Sec. 113 (a)(6)), the holding period includes the period during which the other property was held by the taxpayer.

Sec. 117(h)(2). If the property has a substituted basis determined by reference to the basis of the same property in the hands of another person (the type of basis under Sec. 113(a)(2) and Sec. 113(a)(7). for example), the holding period includes the period during which the property was held by the other person. These rules in Sec. 117(h)(1) and Sec. 117 (h)(2) permit the "tacking" of holding periods, that is, the adding of one holding period to another holding period.

Sec. 117(h)(3) is of only specialized interest and is not discussed; Sec. 117(h)(4) refers to securities acquired on wash sales and is not discussed.

Sec. 117(h)(5). If non-taxable stock dividends or rights, that is, "new stock", are received and a part of the basis of the "old stock" is allocated to the

"new stock" under Sec. 113(a)(19), the holding period of the new stock includes the holding period of the old stock.

Sec. 117(h)(6). If a taxpayer acquires securities through the exercise of rights, the holding period of the securities dates only from the time the rights were exercised; it does not include the period during which the rights themselves were held.

Gains and Losses of Mortgagors and Mortgagees. Several different sections of the Code have to be considered in connection with losses of mortgagors and mortgagees—the loss sections (Secs. 23(e) and 23(f)), the bad debt section (Sec. 23(k)) and the capital gain and loss section (Sec. 117). In certain situations both mortgagors and mortgagees are considered to have realized gain which will in some cases be ordinary income and in others capital gain. The different problems that arise with respect to both losses and gains of mortgagors and mortgagees are treated here together, first from the point of view of the mortgagor and then from the point of view of the mortgagee.

The Mortgagor. The mortgagor sustains a loss when he loses his equity in the property. He may lose his equity in several different ways and the tax effects of the different transactions are not the same.

(1) The mortgagor may lose his equity in property by a foreclosure sale.* The Supreme Court in *Helvering v. Hammel* ** held that a foreclosure sale, although involuntary, is nevertheless a sale. If the property is a capital

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* Throughout this section it is assumed that the loss, if that of an individual, is of a character that is allowable as a deduction under Sec. 23(e), that is, a loss incurred in a trade or business or in a transaction entered into for profit. If the mortgaged property is the taxpayer's residence, the loss is, of course, not deductible.

** 311 U.S. 504 (1941).

asset, the loss is therefore a capital loss under Sec. 117(a). In many cases, however, the property would not be a capital asset but would be "property used in a trade or business" and the loss would come within the provisions of Sec. 117(j). In that case (if there were no gains from other Sec. 117(j) transactions to offset the loss) the loss would be treated as an ordinary loss and deductible in full.

(2) The mortgagor may lose his equity by giving a deed in lieu of foreclosure. The courts have held that if the mortgagor receives any consideration this also is a sale or exchange. If the mortgagor is personally liable on the mortgage, there is consideration passing to him in the release of his liability; in that situation, then, the same rule would apply as in (1) above. If, however, the mortgagor is not personally liable on the mortgage, and receives no consideration in any other form, there is no sale or exchange, so the transaction does not fall within Sec. 117; in that case, the loss (if an allowable loss) is deductible in full as an ordinary loss.

(3) The mortgagor may lose his equity by an abandonment of the property. A complete abandonment, if there is sufficient evidence to support it, is a closed transaction for tax purposes and the loss is allowed in the year of the abandonment. Since there is no sale or exchange in an abandonment, the loss does not come within Sec. 117 and is an ordinary loss.

The mortgagor may in certain situations realize a gain rather than a loss at the time he loses his equity in the property. This can happen only when the mortgage is not a purchase money mortgage * and when the basis of the property is less than the mortgage debt. In that case, if the mortgagor loses the property upon a foreclosure sale

* When the mortgage is a purchase money mortgage, the rule of the Hirsch case applies and no gain is realized; that case is discussed in Chapter 2 at page 27.

(and any deficiency is not or cannot be collected) or by a voluntary conveyance which the mortgagee accepts in satisfaction of the debt, the mortgagor realizes a gain in the amount of the difference between the basis of the property and the amount of the debt. The theory is that the mortgagor received the proceeds of the loan for his own use and benefit and completed the transaction when the property was reconveyed to the mortgagee; the transaction is equivalent to a sale of the property to the mortgagee for the amount of the original mortgage loan.

The Mortgagee. The mortgagee sustains his loss when he is unable to recover the full amount of his loan. He therefore has a bad debt deduction; in some cases he may also have a gain or loss in addition to a bad debt deduction.

(1) The loss of the mortgagee may be realized by a foreclosure sale. When mortgaged property is foreclosed and bid in, either by outside interests or by the mortgagee himself, the mortgagee has a bad debt deduction (rather than a loss deduction) in the amount by which the debt exceeds the amount bid at the foreclosure sale (assuming, of course, that any deficiency is uncollectible). This rule is clear enough when the bid is made by outside interests since the mortgagee's bad debt deduction is then the difference between his investment and the proceeds of the sale. When the mortgagee bids in the property himself he is deemed to have applied the debt obligations, to the extent of the bid price, to the purchase of the property; the balance of the obligations not so applied represents the bad debt. However, when the mortgagee himself bids in the property, he may have an additional gain or loss which is measured by the difference between the bid price and the fair market value of the property. Assume, for example, that the mortgage debt is $100 000, the bid price is $60,000, and the fair market value of the property is $70,000. The bad debt deduction would be $40,000. Under the Regulations (Sec. 29.

23(k)-3) the mortgagee is deemed to have realized a gain of $10,000 on the transaction since he has acquired property of a value of $70,000 in exchange for debt obligations of $60,000.

The provisions of the Code and Regulations with respect to the bad debt deduction and the gain or loss of the mortgagee are unnecessarily complicated, and proposals have been made by several groups for a statutory change which would bring the tax law more into line with economic realities. The mortgagee's loss when he himself bids in the property is actually the difference between the amount of the debt and the fair market value of the property (assuming, again, that no deficiency can be collected) and this should measure the bad debt deduction; the bid price would seem to be of little importance except as some evidence of market value.

(2) The loss of the mortgagee may be realized by his acceptance of a deed to the property in lieu of foreclosure. In that case, the mortgagee is allowed a bad debt deduction in the difference between the amount of the mortgage debt and the fair market value of the property. This would seem to be the proper measure of the bad debt, and is the rule suggested above as the proper measure when the property is acquired by foreclosure sale.

Irrespective of whether the property is acquired by foreclosure sale or by deed in lieu of foreclosure, the basis of the property in the hands of the mortgagee is its fair market value at the date of acquisition.

Sales by Stockholders of Assets Distributed in Kind. A question of great current interest is the one arising from the Supreme Court's decision in the *Court Holding* case:* the question whether certain sales of corporate assets are made by the corporation or by its stockholders. If a cor-

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* Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

poration sells assets which have appreciated in value, the gain will be taxed to the corporation (ordinarily as a capital gain since the assets will usually be either capital assets under Sec. 117(a) or property used in the trade or business under Sec. 117(j)); if the corporation then distributes the balance of the gain (net after tax) to its stockholders, the distribution will ordinarily be subject to a further tax in the hands of the stockholders either as an ordinary or a liquidating dividend. On the other hand, if a corporation distributes appreciated assets to its stockholders in kind, it does not realize gain by the distribution (under the principle of the *General Utilities and Operating* case) and pays no tax. The stockholders pay tax on the full market value of the distribution and can then sell the assets at that value without a further tax. One tax is saved, therefore, if a corporation, instead of selling assets itself, distributes them to its stockholders and the assets are then sold by the stockholders.

This problem was first squarely passed on by the Supreme Court in the *Court Holding* case. In that case, two stockholders owned all the stock of the corporation; and the sole asset of the corporation was an apartment house. Negotiations were entered into by the corporation with a particular purchaser for the sale by the corporation of the apartment house, and an oral agreement was made. Subsequently, the corporation's attorneys advised it of the double tax that would be incurred if the corporation first sold the apartment house and then distributed the proceeds of the sale, after tax, to its stockholders in liquidation. The corporation thereupon refused to go through with the sale and, on the next day, distributed the apartment house to the stockholders in liquidation of the corporation; the stockholders then sold the apartment house to the same purchaser with whom the corporation had negotiated for the sale. The Supreme Court held, on these facts, that the sale was, in substance, made by the corporation; that the

transaction had to be viewed as a whole, and that as thus viewed the stockholders had been used merely as a conduit through which to pass title to the property. The gain on the sale was therefore taxed to the corporation, with the result that two taxes were imposed—one on the gain realized by the corporation on the sale, and the second on the gain realized by the stockholders on the receipt of the proceeds of the sale (net after the corporate tax) as a distribution in liquidation.

No other cases involving this question have yet reached the Supreme Court. The decisions of the lower courts are confusing but they suggest at least the following broad pattern. If the corporation, through its officers or through stockholders acting on its behalf, conducts negotiations for the sale of the corporation's assets and then distributes the assets to its stockholders who proceed to sell them to the *same* person or persons with whom those negotiations were had, the corporation will be deemed to have made the sale. If on the other hand there are no negotiations prior to the distribution, or if the stockholders after the distribution sell to a different person, the sale will be considered as a sale by the stockholders. In one recent case, *Howell Turpentine*,* the Fifth Circuit Court held that the sale was made by the stockholders even though the stockholders had had negotiations with the ultimate purchaser prior to the liquidation; but in that case the stockholders made it clear in all their negotiations that they were acting as individuals and were only agreeing to sell when, as, and if they received the assets.

The problem arises most often when a sale of all a corporation's assets is being considered. In that case the tax problem can usually be avoided by a sale of the stock instead of the assets. But this is often impossible as a busi-

* Howell Turpentine Co. v. Commissioner, 162 F.2d 319 (C.C.A. 5th 1947).

ness matter. The buyer may not be willing to run the risk of unknown corporate liabilities. Also, if a *corporation* buys the stock and subsequently liquidates the company it has bought, it will ordinarily get as its basis for the assets, not the amount it paid for the stock, but the purchased company's own basis for the assets, which may be much less.*

Sec. 118 (Loss From Wash Sales of Stock or Securities) is not discussed in detail. Very briefly, if securities are sold (or otherwise disposed of) at a loss, but other substantially identical securities are acquired by the taxpayer (by purchase or by a taxable exchange) during either the 30-day period preceding the sale or the 30-day period following the sale, the loss is not allowed. The purpose of the provision is to prevent tax avoidance; except for this section a taxpayer could sell securities for a tax loss but at the same time, by a purchase of other substantially identical securities, retain an unchanged interest in the corporation. This section does not apply to an individual if the sale is made in connection with his trade or business, or to a corporation if the corporation is a dealer in securities and the sale is made in the ordinary course of its business.

Sec. 119 (Income From Sources Within United States) sets out the rules for determining what gross income and deduction items are from sources within and without the United States. This section is of general importance only in connection with non-resident aliens and foreign corporations since they are subject to United States tax only on income from United States sources.** It has, in most

* See Sec. 112(b)(6) and Sec. 113(a)(15), discussed, respectively, in Chapter 5 and Chapter 6.

** The section is also important in connection with Western Hemisphere

instances, no relevance to the tax liability of United States citizens or residents or domestic corporations, since they are ordinarily liable for tax on their entire net income irrespective of its source.* The more important rules in Sec. 119 are summarized below.

The items of gross income that are considered as income from United States sources are listed in Sec. 119(a) as the following:

1) Interest from the United States and from the other governmental entities listed in Sec. 119(a)(1), and interest on bonds and other obligations of United States *residents,* corporate or otherwise. There are certain exceptions to this interest rule which are set out in subdivisions (A), (B) and (C) of Sec. 119 (a)(1). The most important is that contained in subdivision (A) which excepts from the general rule interest on bank deposits paid to nonresident aliens and foreign corporations not doing business in the United States; that interest is excepted from the general rule for the practical reason that a tax on such interest would merely tend to drive the banking business of these nonresident aliens and foreign corporations out of this country.

2) Dividends received from:

(A) a domestic corporation, unless such corporation derived less than 20% of its own gross income from United States sources during the three-year period ending with the close of the taxable year preceding the declaration of the dividends.

Trade Corporations since 95% of their income must be derived from sources without the United States (see Sec. 109, discussed in Chapter 4).

* Throughout Sec. 119 and the applicable Regulations there are references to the effect of the section on individuals and corporations entitled to the benefits of Sec. 251 (Income from Sources within Possessions of the United States); since Sec. 251 is of very limited interest, all such references are ignored in the text discussion.

(B) a foreign corporation, unless such corporation derived less than 50% of its own gross income from United States sources during the three-year period ending with the close of the taxable year preceding the declaration of the dividends; only a proportionate part of these dividends, however, is treated as income from United States sources, the proportion depending on the ratio of the paying corporation's United States gross income to its total gross income.

3) Compensation for personal services if the services were *performed* in the United States (with one minor exception in the case of a nonresident alien in this country for only a short period). It is the place of performance *only* and not the place where payment is received that determines the tax status of the income.

4) Rentals and royalties from property (or any interest therein) located in the United States, including rentals and royalties for the use of or privilege of using patents, copyrights, franchises, etc., in the United States.

5) Gain from the sale of real property if the property is located in the United States.

6) Income from the sale of personal property is subject to the special rules of Sec. 119(e), discussed below.

The *net* income from United States sources is the gross income as determined above after deducting the expenses, losses and other deductions that are properly allocable thereto (Sec. 119(b)). When a deduction item cannot be directly allocated to one particular item or class of gross income, the deduction is prorated between gross income from United States sources and gross income from sources without the United States.

The items of gross income from sources *without* the United States are listed in Sec. 119(c). These items are in

every case the converse of the items listed in Sec. 119(a) as items of gross income from sources within the United States. The *net* income from sources without the United States is determined under Sec. 119(d); the method is just the same as that provided by Sec. 119(b) for determining the net income from sources within the United States.

Sec. 119(e) provides certain rules for allocating gross income and deduction items other than those specified in Secs. 119(a) and 119(c); those rules are amplified in the Regulations and are not discussed here. The section also provides, however, certain rules of more general interest covering the allocation of income from the sale of personal property, when the property is produced or purchased within the United States and sold without the United States, or vice versa. These rules are, briefly, as follows:

1) When personal property is *purchase*d within the United States and sold without the United States, or vice versa, the income is treated as derived entirely in the country where the *sale* is made—no part of the income is allocated to the purchase.

2) When personal property is *produced* within the United States and sold without the United States, or vice versa, the income is treated as derived partly in the country where the property was produced and partly in the country where the sale is made—here, a part of the income is allocated to the production.

The place where the sale is made is ordinarily the place where title passes, and the courts have held to this effect. Early Bureau rulings were in conflict with the court decisions and gave weight to the place where the contract was made, the place where the contract was accepted, and the place where the goods were delivered in determining the place of sale. In a recent ruling * the Bureau has modified its

* G.C.M. 25131, 1947-2 C.B. 85.

position and now accepts the general rule that the place of sale is the place where title passes; the ruling provides, however, that, in any case where the transaction is arranged in a particular manner in order to avoid taxes, the general rule will not be applied and all the factors bearing on the transaction will be considered in determining the place of sale.

Sec. 120 (Unlimited Deduction for Charitable and Other Contributions) and Sec. 121 (Deduction of Dividends Paid on Certain Preferred Stock of Certain Corporations) are not discussed.

Sec. 122 (Net Operating Loss Deduction) sets out the method of computing the net operating loss deduction which is allowed by Sec. 23(s). The principles underlying this deduction are relatively simple and it is only the computation of the deduction, as set out in Secs. 122(b), 122(c) and 122(d), that is complicated. This section, in brief, allows the business net operating losses of one year to be taken as deductions against the net income of other years; the allowance of the deduction is an attempt to minimize the inequity that results if a taxpayer is taxed on all the income of good years without being allowed any benefit from losses sustained in bad years. The general intent of the section is to average the business income over a period of years and to impose a tax on only that part of the income of the current year which is not offset by losses of other years just preceding or just subsequent thereto.

The plan of the section is, very generally, as follows. The net operating losses (the excess of deductions over gross income, with certain modifications) for the two years preceding the current year and the net operating losses for the two years subsequent to the current year can be taken

as a deduction in the current year, thereby reducing or wiping out the current year's taxable income. As a simple example, merely to illustrate the basic principle, assume that corporation A had a net operating loss of $10,000 in each of the years 1945, 1946, 1948 and 1949, and a net income (before the net operating loss deduction) in 1947 of $60,000; and that there are no other years to be considered. The losses of 1945 and 1946 could be carried forward to 1947 and the losses of 1948 and 1949 could be carried back; * there would then be a net operating loss deduction of $40,000 in 1947 and A would be taxed on only $20,000 of its 1947 net income instead of on $60,000.

This general statement is, however, subject to many modifications. The most important is that set out in Sec. 122(b) which specifies the order in which a net operating loss of any given year must be applied. If there is, for example, a net operating loss in 1946, that loss must first be carried back to 1944; any excess must then be applied to 1945; if there is still any unused loss, it may then be carried forward, first to 1947 and finally to 1948. Thus, while a net operating loss of any year is applicable against the income of the two preceding and the two succeeding years, the *order* of its application is set by the statute; the taxpayer has no option as to the year in which he will use a net operating loss.

One other very important modification is that contained in Sec. 122(d): the net operating loss is not the excess of the deductions over the gross income as shown on the return but must be adjusted in accordance with the provisions of Sec. 122(d).** These adjustments are intended, *in general,* to convert the operating loss as shown on the re-

* When there is a carry-back of a loss from a later year, the adjustment for the current year has to be made by a refund claim.

** The net income of the year in which the net operating loss deduction is taken must also be adjusted in accordance with the first four provisions of Sec. 122(d).

turn into the real economic loss sustained by the taxpayer. The most important adjustments are: (1) wholly tax-exempt interest is included in gross income; (2) long-term capital gains and losses of individuals are taken into account without the 50% reduction; capital losses in excess of capital gains (after the foregoing adjustment in the case of individuals) are not allowed; (3) deductions of individuals which are not attributable to a trade or business are allowed only to the extent of the gross income not derived from a trade or business. (There is also an adjustment with respect to the deduction for depletion.) Because of the limitation with respect to the non-business deductions of individuals (and estates or trusts), net operating losses of individuals can be carried forward or back only to the extent the net losses result from the operation of a trade or business.

In the actual computation of a net operating loss deduction, there are certain other adjustments to be made besides those cursorily mentioned above. The details contained in the Code are explained in the Regulations; they are too complex to be covered here.

A distinction that should be kept in mind is that between net operating loss carry-overs and capital loss carry-overs. To repeat, a net operating loss is first carried back to the two preceding years and then carried forward for two years; a net capital loss cannot be carried back but can be carried forward for five years.

Sec. 123 (Commodity Credit Loans), Sec. 124 (Amortization Deduction), and Sec. 125 (Amortizable Bond Premium) are not discussed.

CHAPTER 8

SECTION 126 TO SECTION 172

Sec. 126 (Income in Respect of Decedents) is a very important section covering the treatment of income and deduction items that have never been reported in the returns of an individual prior to the time of his death. A little preliminary material may make this section easier to understand.

When an individual dies an income tax return is filed for him (by his executor or administrator) covering the period from the beginning of the taxable year to the date of his death. Thereafter, the executor or administrator files income tax returns for the estate during the period of administration until the estate is finally wound up. For the purpose of this entire section, assume that A is the decedent; that he was a cash basis taxpayer during his lifetime and filed on a calendar year basis; and that he died on April 30, 1948. His executor would file a return for him covering the period January 1, 1948 to April 30, 1948; this return is spoken of as the last return of the decedent and would be filed (on Form 1040) on or before March 15, 1949. If the estate of A also reports on a calendar year basis, the executor would file an income tax return for the estate for the period May 1, 1948 to December 31, 1948; and would thereafter file a return for each subsequent year until the estate was wound up. The return for the estate is filed on the Fiduciary Form 1041 which is similar in most respects to Form 1040. For the year of death, then, two different returns are filed.

Prior to the 1934 Act the law was roughly as follows. At the time of his death, a cash basis taxpayer might have been owed certain amounts of income which had not been received, such as, for example, rents of $1,000 that were due but not paid. Since there had been no receipt of the rents prior to death, the executor or administrator would not have to include them in the decedent's last return. The right to receive the rents would, of course, be an asset of the decedent's estate and, if the estate was sufficiently large to require the filing of an estate tax return, the right would be included in the estate tax return and tax paid on it. If the rents were fully collectible, the right to receive them would be worth $1,000 at the date of A's death. The right to receive the rents would (under Sec. 113(a)(5)) have a basis in the estate's hands of $1,000—fair market value at

date of death. Therefore, when the estate received the $1,000 in payment of the rents, the $1,000 would be received as corpus rather than as income since the amount received would not exceed the basis. The effect was, of course, that the rents were never subject to income tax. The same problem also existed with respect to individuals who reported on the accrual basis. Income items would not have been reported in returns for earlier years or in the last return of the decedent, if all the events which would require a proper accrual of the income had not occurred prior to death.

The question may arise why these rents should be subject to income tax since they have (in the assumed example) been subject to estate tax. The answer is that in most situations the estate tax is not a substitute for the income tax. If A had received these rents prior to his death he would have paid income tax on them; then if he had died, without having spent or lost or given away the rent proceeds, the balance left after the income tax payment would have been an asset in his estate and subject to estate tax. The full amount of the rents would, of course, not have been subject to both taxes; income tax would have been paid on the full amount of the rents and estate tax on the balance remaining after income tax.

In the 1934 Act an attempt was made to subject to income tax these income items (of both cash and accrual basis taxpayers) which had previously entirely escaped the tax. The provisions enacted in the 1934 Act remained in the Code until the 1942 Act when they were replaced by the present provisions of Sec. 126. The 1934 Act provided, in effect, that all these income items were to be included in the last return of the decedent. This succeeded in subjecting all the income to tax but had the unfortunate and inequitable effect of piling up an abnormal amount of income in one return so that it was subject to unduly high surtax rates. It was this defect in the provisions that was responsible for

the complete change made by the 1942 Act in the method of taxing this income.

Sec. 126 was added to the Code as a new section by the 1942 Act and has not been amended since that time. The general plan of the section is that the income items under discussion, such as the rents in the example above, are to be reported as income in the income tax return of the person who receives them after the death of the decedent. There are also, of course, deduction items which might never have been deducted by the decedent either because they had not been paid prior to death or had not accrued. An example in the case of a cash basis taxpayer would be real estate taxes that had accrued but had not been paid prior to death. Sec. 126 also provides, therefore, that these deduction items can be deducted in the income tax return of the person who pays them. There is a further provision in Sec. 126(c) which allows as a deduction that part of the estate tax allocable to the income items included in gross income; this deduction is allowed in order that the *full* amount of these income items shall not be subject to both estate and income taxes. The separate provisions of the section are discussed briefly below.

Sec. 126(a) refers to the income items. Sec. 126(a)(1) provides that any income items which were *not* properly includible in any of the returns of the decedent (including his last return) shall be included, when received, in the gross income of:

> (A) The estate, if the estate acquires from the decedent the right to receive the income. (In the majority of cases these amounts would be received by the estate.)
>
> (B) Any person who, by reason of the death of the decedent, acquires the right to receive the income, in cases where the estate does not acquire such right from the decedent. If, for example, a husband and wife owned a Series E bond jointly and the husband

died prior to the payment of the bond, the wife would include in her income (in the year the bond was paid) the full amount of the payment that represented income. A part of this income would have accrued prior to the husband's death but the full amount would nevertheless be included in the wife's gross income when received.

(C) Any person who acquires the right to receive the income by bequest, devise, or inheritance, and receives the income after the right to it has been distributed to him by the estate, so that the income is received directly rather than through the estate.

Sec. 126(a)(2) provides that, if any person (including the estate) who has the right to receive the income transfers the right to another (as by a sale or exchange or by gift), the fair market value of the right to the income shall be included in the income of the transferor for the year of the transfer. If the right is transferred for a consideration that is greater than its fair market value, the full amount of the consideration is included in income.

Sec. 126(a)(3) provides that, when any of the income items are reported in the return of the estate or of any other person receiving the income, the *character* of the income remains the same as it would have been if the income had been received (or accrued) and reported by the decedent. Thus, if the income would have been capital gain to the decedent, it remains capital gain to the person reporting it; if it would have been tax-exempt interest to the decedent, it remains tax-exempt interest.

Sec. 126(b) refers to the deduction items of expenses, interest, taxes, and depletion, and to the foreign tax credit. A special rule is provided with respect to the depletion deduction which is not discussed. With respect to the other items, the deduction or foreign tax credit is allowed, in the year in which the item is *paid,* to:

(A) The estate—in most cases the estate would be

liable for the obligation and the payment would be made by the estate; or

(B) The person who (by reason of the death of the decedent or by bequest, devise, or inheritance) acquires from the decedent an interest in property subject to the obligation and who pays the obligation, in cases where the estate is not liable for the obligation. An example would be a person who paid real estate taxes on property acquired by devise, which taxes had accrued prior to the decedent's death but for which the decedent had not been personally liable.

Sec. 126(c) provides for a *deduction* of a part of the estate tax in the income tax return of the estate or person who includes any of the Sec. 126(a) income items in gross income. Referring again to the example of the rents of $1,000, the full amount of the rents should not be subject to both estate and income taxes, since that would be a greater tax burden than would have been imposed if the rents had been received during the decedent's lifetime. Under this section (assuming those rents are the only income item under Sec. 126(a) and that there are no deduction items), if the rents are reported in the income tax return of the estate or of another person, a deduction is allowed for the estate tax allocable to the rents. In effect, the income tax is levied on the rents less the estate tax payable on them. The estate tax allocable to the rents would be the difference between the estate tax with the rents included in the gross estate and the estate tax that would have been payable if the rents had not been included in the gross estate.

The actual operation of Sec. 126(c) is more complicated than the above example would indicate since, in computing the deduction for the estate tax, the taxpayer has to take into account all the income items and all the deduction items under Sec. 126 which were reflected in the estate tax return,

and determine the amount of estate tax properly attributable to the particular income items that are included in the income tax return. An example in the Regulations (Sec. 29.-126–3) provides a clear explanation of the exact method of computing the deduction.

Sec. 127 (War Losses), Sec. 128 (Recovery of Unconstitutional Federal Taxes), Sec. 129 (Acquisitions Made to Evade or Avoid Income or Excess Profits Tax), and Sec. 130 (Limitation on Deductions Allowable to Individuals in Certain Cases) are not discussed.

Sec. 131 (Taxes of Foreign Countries and Possessions of United States) provides for the credit of certain income taxes of foreign countries and United States possessions against the United States tax and was referred to in Chapter 3 in connection with the discussion of the deduction of foreign taxes. It should be noted that this section applies only to foreign *income* taxes * (including war-profits and excess-profits taxes). Sec. 23(c) allows the *deduction* of foreign income taxes if they are not taken as a credit under Sec. 131. Sec. 131 provides that, in certain instances, foreign income taxes can be taken as a *credit* against the United States tax rather than as a deduction. A credit against the tax ordinarily results in a greater tax benefit than a deduction from gross income. For example, assume that an individual, who is unmarried, has gross income of $10,000, deductions (not including any foreign taxes) of $2,000, and a personal exemption of $500; and that he has also paid a foreign income tax of $1,000. He can,

* The term "foreign income taxes" is used in the text to include income taxes of United States possessions except where there is a difference in the tax treatment of the two taxes.

under Sec. 23(c), take the foreign tax as a deduction; then his taxable income would be $6,500 and his United States tax would be $1,308.80. Or, he can take the foreign tax as a credit against the United States tax rather than as a deduction. In that case his taxable income would be $7,500 on which the United States tax would be $1,572.80; he would then credit the foreign tax against the United States tax (that is, subtract it directly from the United States tax) and his United States tax liability would be only $572.80.*

There are certain limitations with respect to the persons who are allowed to take foreign income taxes as a credit; and also with respect to the amount of the foreign income taxes that can be taken as a credit. These limitations are discussed briefly below.

Sec. 131(a) lists for different classes of taxpayers the conditions under which the foreign tax credit is allowed. Citizens and domestic corporations are allowed a credit for income taxes paid or accrued to any foreign country or possession of the United States. A different rule is prescribed for alien residents. They are allowed a credit for taxes paid or accrued to a possession of the United States; but they are allowed a credit for taxes paid or accrued to a foreign country only if the country of which they are citizens or subjects has a reciprocal provision in its own laws, that is, if that country allows a similar credit to United States citizens residing there. The term "alien residents" includes only individual aliens who are resident here. It should be noted that no credit is allowed to nonresident alien individuals or to foreign corporations.

When a citizen or a resident alien is a member of a partnership or a beneficiary of an estate or trust, he is allowed his proportionate share of the taxes paid or accrued by the partnership or estate or trust to a foreign

* This assumes that the amount of the foreign tax credit is not reduced by the limitations of Sec. 131(b), discussed below.

country or possession of the United States; in the case of a resident alien, the allowance of this credit is subject to the same limitation that is prescribed with respect to foreign taxes paid directly by the resident alien as an individual.

Sec. 131(b) sets out the limitations on the *amount* of the credit that can be taken. The rules in Secs. 131(b)(1) and 131(b)(2) are rather complicated and can be worked out most easily from the examples given in the Regulations (Sec. 29.131-8). As explained briefly below, there are two separate limitations and the credit cannot exceed *either* of the limitations.

Sec. 131(b)(1) states the limitation with respect to the credit for taxes paid or accrued to one particular country. Here, the credit for the foreign income tax cannot exceed the United States tax attributable to the income from the foreign country; the United States tax attributable to the foreign income is determined by the proportion of the foreign income to the total income of the taxpayer. The reason for this limitation will be clear from a simple example. Assume that a taxpayer received income of $10,000 from sources within Great Britain on which the British tax was $5,000, or at a rate of 50%; and assume that the United States tax attributable to the foreign income was $4,000, or at a rate of 40%. The credit for the British tax is limited to $4,000, or to the amount of United States tax attributable to the British income; without this limitation, the credit would offset United States tax payable on purely United States income which would discriminate against the revenues of this country. The general effect of this limitation is that the total tax paid on the foreign income is equivalent to the higher of the foreign or the United States tax.

Sec. 131(b)(2) provides the second limitation which applies only when a taxpayer has transactions in more than one foreign country. In that case, the credit for all the foreign taxes cannot exceed the United States tax attributable to the *net* foreign income. This limitation is more

stringent than the limitation under Sec. 131(b)(1) only where the transactions in one or more of the foreign countries result in a loss. Assume, for example, that a taxpayer received income of $10,000 from sources within Great Britain on which the British tax was $5,000, and had losses from Canadian transactions of $5,000, and that his United States income was $28,000. The United States tax on the total income of $33,000 would be approximately $13,200, or at an effective rate of 40%. The total foreign taxes on the *net* foreign income of $5,000 would be $5,000 (*i.e.*, the British tax). Under Sec. 131(b)(2) the credit could not exceed $2,000, the proportion of the United States tax that the net foreign income is of the total income. If Sec. 131(b)(1) alone were applicable, the allowable credit would be $4,000.

The other subsections of Sec. 131 are not discussed. Sec. 131(f) should, however, be examined with great care in any case involving a domestic corporation which receives dividends from a foreign subsidiary in which it owns a majority of the voting stock, since in that case the domestic corporation is allowed a tax credit for a part of the foreign taxes paid by the foreign subsidiary.

Sec. 141 (Consolidated Returns) and Sec. 142 (Fiduciary Returns) are not discussed. Sec. 142 sets out the requirements for the filing of returns by fiduciaries. The section provides, among other things, that a return must be filed for every estate which has a gross income of $600 or more, and for every trust which has a gross income of $600 or more or a net income of $100 or more. These returns are filed on the Fiduciary Form 1041. The requirements for filing are sufficiently clear from the Code provisions.

Sec. 143 (Withholding of Tax at Source) provides for the withholding of tax at the source on certain tax-free cove-

nant bonds and on income payable to nonresident alien individuals. Only Sec. 143(b) dealing with nonresident aliens is discussed, and that only briefly.

Sec. 143(b) provides generally that all persons, in whatever capacity they are acting, such as employers, fiduciaries, lessees, etc., who pay over income to nonresident alien individuals, or who have control or custody, etc., of such income, must withhold from the income a tax of 30% and pay the tax over to the Collector of Internal Revenue. The withholding rates under this section and Sec. 144 have been reduced in some cases by treaties entered into with certain foreign countries. The section applies only to income from United States sources since nonresident aliens are not taxed on income from foreign sources. Further, the section applies only to income that is "fixed or determinable annual or periodical gains, profits, and income". This definition *excludes* capital gains and tax is not withheld on such gains. The reason for this exclusion is that nonresident aliens, except those who are doing business in this country, are not taxed on capital gains. It should be noted, however, that the withholding provision applies to both nonresident aliens doing business here and those not doing business here; in other words, the section applies to all nonresident aliens receiving income from United States sources. As stated above, the section applies not only to persons who pay over income to a nonresident alien but also to those persons who have control or custody of the income. As an example, the income of certain types of trusts is taxable to the beneficiary under Sec. 162(b), discussed below, whether or not it is distributed to him; in such a case, if the beneficiary is a nonresident alien, the trustee has to withhold 30% of the income as tax, even though the income is not actually paid over to the beneficiary.

The foregoing is only a brief resume of the general provisions of the section. There are many detailed provisions

in the statute and Regulations covering situations where withholding is or is not required, and these should be read with care. The section is also easier to understand if it is read in connection with Sec. 211 (discussed in Chapter 9) which deals with the method of taxing nonresident aliens. The basic reason for the requirement that tax be withheld on the income of nonresident aliens is that, in many instances, it is the only way of ensuring the collection of the tax.

Sec. 144 (Payment of Corporation Income Tax at Source) provides for the withholding of income tax on income payable to foreign corporations not doing business in this country in the same manner and at the same rate that tax is withheld on income payable to nonresident alien individuals under the provisions of Sec. 143. It should be noted that Sec. 144 applies only to foreign corporations not doing business in this country whereas Sec. 143 applies to nonresident alien individuals whether or not they are doing business here.

Sec. 145 (Penalties), Sec. 146 (Closing by Commissioner of Taxable Year), Sec. 147 (Information at Source), Sec. 148 (Information by Corporations), Sec. 149 (Returns of Brokers), Sec. 150 (Collection of Foreign Items), and Sec. 151 (Foreign Personal Holding Companies) are not discussed. Sec. 145 deals only with criminal penalties; the provisions covering civil penalties are contained in Sec. 291 and Sec. 293 (discussed in Chapter 10). Sec. 147 is the section which provides that persons making income payments to another person of $600 or more must file certain information returns reporting the payments. The purpose of this requirement is to enable the Government to cross-check the returns of the recipients of the payments. For the same reason, Sec. 148 requires corporations to report

dividend payments, in excess of certain amounts, made to their stockholders; this section also requires a corporation to file an information return stating the terms of any plan of liquidation within thirty days after the adoption of such a plan. Sec. 151 refers only to information returns with respect to foreign personal holding companies; the provisions covering the taxation of foreign personal holding company income are contained in Supplement P (discussed in Chapter 11).

Secs. 161–172—Estates and Trusts.

Introduction. These sections which make up Supplement E of the Code contain the provisions governing the taxation of the income of trusts and estates. Secs. 161–164 deal with ordinary or "strict" trusts, and with estates during the period of administration; the income of these trusts and estates is taxed either to the beneficiary or to the trust or estate. Sec. 165 deals with employees' pension and profit-sharing trusts and plans. Sec. 166 and Sec. 167 deal with certain types of trusts the income of which is taxed to the grantor rather than to either the beneficiary or the trust. Sec. 171 deals with certain alimony trusts. Besides the trusts covered by the provisions of Supplement E, there is another group of trusts ordinarily called Clifford trusts, the income of which is taxed to the grantor under the broad provisions of Sec. 22(a); those trusts are discussed below, immediately following the discussion of the Sec. 166 and Sec. 167 trusts, since the income of all three of those types of trusts is taxed to the grantor.

The taxation of trusts is one of the most complicated parts of income tax law and this book does not attempt a comprehensive treatment of the subject. In the following discussion, the rules with respect to the taxation of the different types of trusts are set out in only very broad outline, with many details and refinements omitted.

Ordinary Trusts and Estates in the Process of Administration. The provisions relating to these trusts and estates are contained in Secs. 161–164; under these sections the income of these trusts and estates is taxed either to the beneficiary or to the trust or estate.

Income of trusts and estates is in some cases distributed to the beneficiaries in the year the income is received, and in other cases is not distributed to them until some period after the close of the taxable year. Since it is a general theory of tax law that two persons should not be taxed on the same income, the basic problem with respect to the income of ordinary trusts and of estates during the period of administration is that of determining whether the income is to be taxed to the trust or estate or to the beneficiary. The law does not contemplate that the income shall be taxed to the trust or estate in the year when it is received and then taxed again to the beneficiary in a later year when it is distributed to him.

The method, in general, of treating trust and estate income is as follows: the fiduciary (trust or estate) files a return on the Fiduciary Form 1041 and reports in that return *all* the taxable income; the fiduciary then deducts the income that is either distributable to a beneficiary (under Sec. 162(b)) or paid or credited to a beneficiary (under Sec. 162(c)); the fiduciary pays the tax on the balance of the income if any. The beneficiary reports in his own return the amount that was deducted by the fiduciary either as income that was distributable or as income that was paid or credited, and pays the tax on that amount. The exact meaning of the terms "the amount distributable" and "the amount paid or credited" will be clearer from the discussion below of the provisions of Secs. 162(b) and 162(c).

—**Sec. 161 (Imposition of Tax)** provides in its first subsection that the income tax applies to the income of estates

and trusts, including the income of the following four classes:

1) Income (a) accumulated for the benefit of unborn or unascertained persons of persons with contingent interests, or (b) accumulated for future distribution under the terms of the will or trust;
2) Income which is to be distributed *currently* to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as a court may direct;
3) Income received by estates during the period of administration;
4) Income which, in the discretion of the fiduciary, may be either distributed or accumulated.

Sec. 161(b) provides that the tax on the *net* income of the trust or estate shall be paid by the fiduciary (except in the case of Sec. 166 and Sec. 167 trusts). This provision does not however determine the question of who actually bears the burden of the tax, since, as stated above, the fiduciary is allowed to deduct, under Secs. 162(b) and 162 (c), in determining its net income, the income that is either "distributable" or "paid or credited" to beneficiaries.

—**Sec. 162 (Net Income)** provides, in its first sentence, that the net income of an estate or trust is to be computed in the same manner as the net income of an individual, *except* as different provisions are made applicable by Secs. 162 (a)–162(f). Those sections are discussed in the following paragraphs. Of those sections, by far the most important are Secs. 162(b) and 162(c).

Trusts and estates are not limited to the 15% deduction allowed to individuals for charitable contributions. Sec. 162(a) provides that they may deduct, without limitation, any part of their gross income paid or permanently set aside during the taxable year for religious, charitable or educational, etc., purposes.

Income Currently Distributable. Sec. 162(b) contains the rules with respect to income of an estate or trust that is *currently distributable.* The first sentence provides that the income of an estate or trust which is to be distributed currently to the beneficiaries shall be deducted by the fiduciary in computing net income; and that the amount deducted shall be reported as income by the beneficiaries whether or not it is actually distributed to them. This section applies to trusts more often than to estates since the income of an estate during the period of administration is not ordinarily currently distributable. Also, the section applies *only* if the income is currently distributable, and does not apply, for example, to trusts where the income must be accumulated, or to trusts where the income may be accumulated or distributed in the discretion of the trustee.

The question whether income is currently distributable depends on the terms of the will or trust instrument as they would be interpreted under the state law governing the instrument. (A simple example of a trust in which the income is currently distributable would be a trust which provided that the income was to be paid to A during his lifetime, remainder to B.) While the taxable income of the trust or estate that is reported in the fiduciary return is determined in accordance with the tax law, the meaning of "income" in the sense of *distributable* income is determined in accordance with the terms of the will or trust instrument and the state law governing the instrument rather than according to tax concepts. For example, under ordinary rules of trust accounting, capital gains are not considered income but are an addition to the corpus of the trust, although under income tax law capital gains are income. Unless, therefore, a trust instrument provides differently, capital gains are not a part of the distributable income of a trust and are not taxed to the beneficiary. The capital gains, since they are income under the tax law, are

reported in the return of the fiduciary; since they are not deducted as part of the distributable income, they remain taxable to the fiduciary.

The important point to keep in mind in connection with Sec. 162(b) is that it does not matter whether the income is actually paid to the beneficiary or not. If the income is currently *distributable* to the beneficiary under the terms of the trust instrument, it is taxable to him; this rule is a specific application of the general rule that income is taxable to the person who has an actual, present right to receive it, whether or not there is an actual receipt. The reason for the rule appears very clearly in the case of trusts. Suppose, for example, that a trust had income of $10,000 and that the beneficiary had income (not including the trust income) of $50,000; it would clearly be to the tax advantage of the beneficiary to postpone actual receipt of the income if that would make the income taxable to the trust. Because of the provisions of Sec. 162(b) such postponement would have no tax effect if the income was currently distributable under the terms of the trust instrument since the income would be taxable to the beneficiary whether or not it was distributed to him.

The second sentence of Sec. 162(b) provides that the term "income which is to be distributed currently" includes income for a taxable year of the estate or trust which, within that year, becomes payable to a beneficiary. This provision was added by the 1942 Revenue Act to cover two specific situations: (1) where income is paid over to a beneficiary upon the termination of the administration of an estate; and (2) where income of a trust for accumulation is paid over to a beneficiary upon the happening of a specified event, such as the beneficiary's becoming twenty-one years of age. Suppose, for example, that either of those events occurred on June 15 of a particular year. Under the law prior to the 1942 Act, the income of the estate or trust for the period January 1 to June 15 of the year of distribution (assuming that the estate or trust is on a calendar year

basis) would have been taxed to the estate or trust rather than to the beneficiary. Under the present provision, that income is taxed to the beneficiary.

Income Paid or Credited. Sec. 162(c) contains the rules relating to income of the following two classes:

1) Income received by estates during the period of administration, and
2) Income of trusts or estates which, in the discretion of the fiduciary, may be either distributed to a beneficiary or accumulated.

In both those cases, the fiduciary deducts only the income that is actually *paid or credited* to the beneficiary; and the beneficiary includes only that amount in his income. The main distinction between this section and Sec. 162(b) is that under this section the fiduciary deducts (and the beneficiary is taxed on) only the income actually paid or credited, while under Sec. 162(b) the fiduciary deducts (and the beneficiary is taxed on) the income that is "distributable". Assume, for example, that a trust provided that the trustee should pay over to A such part of the income of the trust as the trustee deemed advisable until A reached the age of thirty years, and should thereafter pay over the entire income to A. During the period before A reached the age of thirty years, A would be taxed on only that part of the income actually paid over to him and the income that was accumulated would be taxed to the trust, under Sec. 162(c); after A reached the age of thirty years, he would be taxed on the entire income of the trust, under Sec. 162(b).

As stated above, in determining income "currently distributable" (under Sec. 162(b)) the term "income" is interpreted according to principles of trust accounting. In most cases this raises no problem since if an item is "corpus" under trust law it cannot be paid out to the life beneficiary and therefore cannot be currently distributable income. In the case of income "paid or credited" under

Sec. 162(c), and also in the case of income distributed by an estate upon termination or by a trust for accumulation upon the happening of a specified event under Sec. 162(b), the term "income" as used in the statute has presumably the same meaning. Since in those cases, however, a distribution may be made up of items of "corpus" or items of "income" or both, the question arises whether the amount of "income" distributed is to be determined on the basis of trust accounting or in accordance with tax concepts. The rulings and decisions on this question are at the moment too conflicting and inconclusive to be discussed here.

Rules Relating to Both Secs. 162(b) and 162(c). Sec. 162 (d) provides certain rules that are to be applied in determining the amounts that are "distributable" or "paid or credited" out of income under the provisions of Secs. 162(b) and 162(c). These provisions are the result of patch-work amendments made by the 1942 and the 1943 Revenue Acts and as a result are extremely complicated. It is impossible to explain within the compass of this book the exact effect of the provisions; the following paragraphs, therefore, merely point out the two main problems that the section was designed to meet and the general solutions attempted by the section. The Regulations under this section clarify its detailed provisions and give examples of their application.

The first problem concerned annuity trusts. It arose from the fact that the Supreme Court had held, prior to the enactment of this section, that when an annuity of a fixed amount was payable by a trust or estate (and was a charge against corpus if the income was insufficient) the annuity was not taxable to the beneficiary irrespective of whether it was paid out of income or corpus; the income therefore remained taxable to the trust or estate.* Sec. 162(d)(1)

* See Burnet v. Whitehouse, 283 U.S. 148 (1931); Helvering v. Butterworth, 290 U.S. 365, 370 (1933).

changes this rule so that an annuity is taxable to the beneficiary rather than to the estate or trust to the *extent* it is paid out of income.

The second problem was that which arose in connection with so-called "Dean trusts". As pointed out before, in many cases the tax on the income of a trust would be less if the income were taxed to the trust rather than to the beneficiary. Prior to the amendments made by the 1942 Act, many trusts were created with a provision that the income of each taxable year should be distributed to the beneficiary at some date subsequent to the end of the taxable year. For example, the trust instrument might provide that the income of the trust for each calendar year should be distributed to the beneficiary on January 3rd of the following year. These trusts have been known as "Dean trusts" from a case of that name.* Under prior law, since the income of these trusts was not "distributed" or "distributable" during the taxable year of the trust, the income was taxed to the trust; the beneficiary received the income in the following year but was not taxed on it since it had already been taxed to the trust.

The main solution to this problem provided by Sec. 162(d) is the "sixty-five day rule". Under that rule, if, during the first 65 days of the taxable year of an estate or trust, income of the preceding year becomes payable, the income is treated as though it had been paid or been distributable on the last day of the preceding taxable year. The income is therefore taxable to the beneficiary in the preceding year rather than to the trust. If income of any period becomes payable *more* than 65 days after the beginning of the taxable year, the income is treated as income of the taxable year that is paid or distributable; this income is taxed to the beneficiary only to the extent of the income of the estate or trust for the taxable year. This latter rule is the so-called

* Commissioner v. Dean, 102 F.2d 699 (C.C.A. 10th 1939).

twelve-month rule of Sec. 162(d)(2) as modified by the provisions of Sec. 162(d)(4). Both the sixty-five day rule and the twelve-month rule are applicable, not only to the income of Dean trusts, but also to income that is distributed upon the termination of an estate and to income of a trust for accumulation that is paid over to a beneficiary upon the happening of a specified event (see page 257 above). The sixty-five day rule and the twelve-month rule are far more complicated than the foregoing statement would suggest and that statement should be understood as merely an indication of the purpose and meaning of the rules.

Sec. 162(e) refers to items that may be taken as deductions either in the estate tax return or in the income tax return of the estate, but not in both.* If the items are taken as deductions in the income tax return of the estate, there must be filed with the return a statement to the effect that the items have not been claimed as deductions for the purpose of the estate tax, and a waiver of any right to have them allowed for the purpose of that tax. Sec. 162(f) provides that the standard deduction shall not be allowed to estates or trusts.

Sec. 163 (Credits Against Net Income) provides the credits against net income allowed to estates and trusts and is comparable to Sec. 25 which provides the credits in the case of individuals. An estate is allowed, in lieu of the personal exemptions allowed individuals, a credit of $600, and a trust is allowed a credit of $100. The credit for partially tax-exempt interest is allocated between the estate or trust and the beneficiary, the proportion depending on the amount of such interest each is required to report.

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* There is an exception in the case of deductions claimed in the income tax return under Sec. 23(w); those items can be taken as deductions in the income tax return of the estate even though they have been taken as deductions in the estate tax return.

Sec. 164 (Different Taxable Years) sets out the rule for determining the year in which a beneficiary is taxable on his share of the distributable income of an estate or trust under Sec. 162(b) when the taxable year of the beneficiary is not the same as that of the estate or trust. The beneficiary includes in his income for each taxable year his share of the distributable income of the estate or trust for the taxable year of the estate or trust which *ends* with or within his taxable year. If the beneficiary, for example, reports on a calendar year basis and the estate or trust has a fiscal year ending on August 31, the beneficiary would report in his 1948 return his share of the distributable income of the estate or trust for its fiscal year ending on August 31, 1948. This is the same rule that is provided with respect to partnerships, discussed in Chapter 9.

Sec. 165 (Employees' Trusts) which deals with employees' pension and profit-sharing plans and trusts is a very important section but one that is discussed only very briefly. While this section is of great importance to many corporate taxpayers, an adequate discussion of its provisions would require many more pages than can appropriately be given to it here.

In general, the section contains the rules for determining whether employees' pension or profit-sharing trusts or plans are "qualified" trusts or plans, *i.e.,* qualify for special, favorable tax treatment. Sec. 165(a) provides that if the many requirements of that section are met the trust is a tax-exempt trust. The provision for the tax exemption of the trust is not, however, the factor of real importance in connection with Sec. 165. The importance of Sec. 165 lies in the provisions of Sec. 23(p) covering the employer's contributions to an employees' pension or profit-sharing plan and the provisions of Sec. 22(b)(2)(B) and Sec. 165 (b) covering the employees' benefits.

Under those provisions, if a pension or profit-sharing

plan qualifies under Sec. 165, the employer can deduct his contributions to the plan (with certain limitations) in the year in which they are made. The employee, however, is not taxed in that year, but is taxed only in the later year or years in which he actually receives distributions. In the case of a pension plan, for example, the provisions allow an employer to deduct, over the period of an employee's service, the cost of providing retirement income for him. The employee, on the other hand, pays tax only in the years after retirement when he receives his pension payments; in those years, since his income is ordinarily less, the pension payments are taxed at lower rates.

If an employees' pension or profit-sharing plan does not qualify under Sec. 165, two general rules apply: (1) if the employees' rights in the employer's contributions are *non-forfeitable,* the employer can deduct the contributions in the year in which they are made, but each employee must report the contributions made on his behalf as income in that year; (2) if the employees' rights in the employer's contributions are *forfeitable,* the employer cannot deduct the contributions and the employee does not report any amount as income in that year.

Secs. 23(p) and 165 constitute an exception to the general theory and practice of the tax law since, under the usual rules, amounts deducted in one year by an employer as compensation to employees would be reported as income by the employees in the same or the following year. The exception is granted in the case of employee plans which qualify under Sec. 165 as a part of a public policy of encouraging incentive and retirement income plans.

Trusts Taxable to the Grantor. Sec. 166 and Sec. 167 relate to certain types of trusts the income of which may be taxed to the grantor of the trust rather than to either the beneficiary or the trust. Sec. 166 relates to trusts where there is a power to revest the *corpus* of the trust in the grantor.

Sec. 167 relates to trusts where the *income* of the trust may be used for the benefit of the grantor. If the income of a trust is taxable to the grantor under either of these two sections, the provisions of Secs. 161–164 dealing with ordinary trusts have no application. The trusts that fall within the scope of Sec. 166 and Sec. 167 must also be distinguished from Clifford trusts (discussed later in this chapter), the income of which is taxed to the grantor *only* under the provisions of Sec. 22(a). The income of Clifford trusts is taxed to the grantor *in spite of* the fact that such trusts do not come within the provisions of Sec. 166 or Sec. 167.

—**Sec. 166 (Revocable Trusts)** provides that all or a part of the income of a trust is taxable to the grantor if a power to revest in the grantor title to all or a part of the corpus of the trust is vested in any of the following persons:

1) The grantor acting alone;
2) The grantor acting in conjunction with any person who does not have a substantial adverse interest in the disposition of the corpus (or a part of it) or the income therefrom;
3) A third person acting alone who does not have the substantial adverse interest set out in (2) above.

It should be noted that it is the *existence* of the power to revest that makes the income taxable to the grantor; it is immaterial whether the power is exercised. The theory underlying this section is that, so long as such a power to revest the corpus in the grantor exists, the grantor remains in substance the owner of the corpus and is therefore taxable on the income from it. While the power exists, the grantor can reacquire the property and hence the income from it; and, since for tax purposes a power to receive income is equivalent to its actual receipt, the income is taxed to the grantor. While the power remains unexercised, the beneficiary receives the income only

because the power has not been exercised; that is substantially equivalent to a receipt of the income by the grantor followed by a payment over to the beneficiary.

A trust is treated as revocable under this section even though the power to revest is not vested in the grantor himself, but is vested in a third person without a substantial adverse interest, or in the grantor acting in conjunction with such a third person. The tax law takes the practical view that unless the interest of the third person is both adverse and substantial the third person will accede to the wishes of the grantor. It has been held that the interest of a trustee as such is not a substantial adverse interest. The interest of an income beneficiary or of a remainderman is ordinarily a substantial adverse interest. But if the quantum of the interest of a particular income beneficiary is very slight in comparison with the total income of the trust, the interest will not be considered as substantial, even though it is adverse. Also, a beneficiary may be considered as not having a substantial adverse interest if his interest is contingent and the contingency is very remote. There have been a great many cases involving the question whether a particular interest is a substantial adverse interest, some of which have arisen under the gift tax rather than under the income tax provisions of the Code; the question is one of fact to be determined by a consideration of the nature and the relative size of the interest.

If the power to revest affects only a part of the corpus, only the income from that part is taxable to the grantor; in other words, a trust may be treated as in part revocable and in part irrevocable. The Regulations define a power to revest to include a power to revoke, to terminate, to alter or amend, or to appoint; the particular method by which the power may be exercised is immaterial. It should be noted, however, that Sec. 166 applies only if there is a *power* to revest. If, for example, the corpus of a trust is to revert to the grantor upon the expiration of a term of

years, the income is not taxable to the grantor under this section; the income may be taxable to him, however, under the rules relating to Clifford trusts.

When a trust comes within the provisions of Sec. 166, the gross income of the trust is included in the grantor's income and the grantor is allowed the deductions allocable thereto in the same manner as though no trust had ever been created.

—**Sec. 167 (Income for Benefit of Grantor)** provides that all or a part of the income of a trust is taxable to the grantor if all or a part of the income may, in the discretion of certain specified persons, be:

1) held or accumulated for future distribution to the grantor, or
2) distributed to the grantor, or
3) used to pay premiums on life insurance policies on the life of the grantor (with one minor exception relating to policies payable to charitable, religious, educational, etc., organizations).

The section applies if the discretion as to the use of the income is vested in any of the following persons:

1) The grantor acting alone;
2) The grantor acting in conjunction with any person not having a substantial adverse interest in the disposition of the income or the particular part of it;
3) A third person acting alone if he does not have the substantial adverse interest set forth in (2) above.

It should be noted that the above three groups are essentially the same three groups set out in Sec. 166 above.

Under the first two provisions of Sec. 167 (Secs. 167(a)(1) and 167(a)(2)), the income of a trust is taxable to the grantor if the income can be either distributed to him currently or accumulated for future distribution to him. As under Sec. 166, it does not matter whether the income actually *is* distributed to or accumulated for the grantor—it is

the existence of the power and not its exercise that makes the income taxable to the grantor. Under the Regulations, the section applies unless the grantor has divested himself of every right which might by any possibility enable him to have the income distributed to him; under this rule the grantor is taxable on the income even though the power cannot be presently exercised and even though the contingency on which the future exercise of the power depends is very remote. The courts have not always adopted this extreme position and have held in some cases that the section did not apply when the possibility of the grantor's receiving the income was remote and was contingent on circumstances over which the grantor had no control.

The section applies, not only in the instances where the income may be distributed to the grantor, but also where the income can be used to satisfy his legal obligations. If, for example, the income may be used to pay the grantor's debts, whether or not it is so used, the income will be taxable to him. Prior to the 1943 Act, this general rule applied where the income of a trust could be used for the support of beneficiaries whom the grantor was legally obligated to support; trusts of this particular type are now covered by the special provisions of Sec. 167(c), discussed below.

The purpose of the third provision of Sec. 167 (Sec. 167 (a)(3)) is to prevent the avoidance of tax through the use of funded insurance trusts, under which insurance policies on the grantor's life and income-producing securities or other property are transferred to a trust and the income from the securities or other property is used to pay the premiums on the insurance policies. As under the other provisions of Sec. 167, the income of these funded insurance trusts is taxable to the grantor if the income *may* be used for the payment of the premiums, irrespective of whether the income is actually so used. It should be noted that this section applies, by its specific terms, only when the income of the insurance trust may be applied to the payment of

premiums on insurance policies on the life of the *grantor*. The Board, therefore, had held in several cases that the section did not apply when a wife was the grantor of the trust and the income was used to pay premiums on insurance policies on the life of the husband. Later Circuit Court decisions have held, however, that under certain circumstances the grantor-wife is taxable on the income of this type of insurance trust under the provisions of Sec. 167(a)(1). For example, even though the insurance policies are on the life of the husband, the grantor-wife is taxable on the income of the trust if she is the beneficiary of the policies or is entitled to the cash surrender value, since in that case the income if the trust is, in effect, being "accumulated for future distribution to the grantor".

Sec. 167(c) provides a special rule with respect to trusts the income of which may be used for the support of beneficiaries whom the grantor is legally obligated to support. This section was added to the Code by the 1943 Revenue Act in order to abrogate the decision of the Supreme Court in the *Stuart* case.* As pointed out above, under the general rule of Sec. 167(a) the income of a trust is taxable to the grantor if it may be used to satisfy his legal obligations, whether or not it is so used. Under this general rule, the Supreme Court held, in the *Stuart* case, that a grantor was taxable on the income of trusts set up for the benefit of his minor children where the trust instruments gave the trustee (who had no adverse interest) discretionary power to use the income for the support and education of the children, although none of the income had actually been so used. In the year following the *Stuart* decision, Sec. 167(c) was enacted in order to change that rule.

Under the provisions of the present section, the income of such a trust is not taxable to the grantor merely because the income *may* be used for the support of a beneficiary

* Helvering v. R. Douglas Stuart, 317 U.S. 154 (1942).

whom the grantor is legally obligated to support (wife and minor children), if the discretion as to the use is vested in another person, or in the trustee, or in the grantor *acting as trustee;* in those cases the income of the trust is taxable to the grantor only if and to the extent that the income is actually used for the support of the beneficiary. If, however, the discretion as to the use is vested in the grantor and he is not a trustee, the income of the trust will be taxable to the grantor to the extent that it may be used for the support of the beneficiary irrespective of whether it is actually so used.

—Clifford Trusts. The other broad group of trusts the income of which is also taxed to the grantor are those called Clifford trusts. The income of those trusts is taxed to the grantor under the broad provisions of Sec. 22(a) rather than under the provisions of Sec. 166 or Sec. 167. The rules governing the taxation of those trusts are contained in Sec. 29.22(a)-21 of the Regulations.

In the *Clifford* case,* decided by the Supreme Court in 1940, Mr. Clifford had created a trust of which he was the trustee; the income was to be distributed to his wife or accumulated for her benefit, in the discretion of the grantor-trustee, for a period of five years, and at the end of that time the corpus of the trust was to revert to the grantor; the grantor also retained broad powers of management over the trust corpus, such as the right to vote the stock representing the corpus and the right to sell or exchange any of the securities. This trust did not come within the provisions of either Sec. 166 or Sec. 167 since there was no power to revest the corpus of the trust in the grantor, and since the income could not be used for the benefit of the grantor. The Supreme Court held, however, that the income of the trust was taxable to the grantor under the broad provisions

* Helvering v. Clifford, 309 U.S. 331 (1940).

of Sec. 22(a) since the grantor remained *in substance* the owner of the trust corpus. The decision was based on (1) the short duration of the trust, (2) the fact that the grantor's wife was the beneficiary, and (3) the substantial powers of management and control retained by the grantor. The Court held that the creation of the trust resulted merely in a temporary reallocation of income within the family group and that, after the creation of the trust, the grantor still retained, in substance, the enjoyment of all the rights he previously had in the property.

In the following year, the Clifford doctrine was applied by the Second Circuit Court of Appeals to a *long-term* trust in the *Buck* case.* In that case, the grantor had created a trust with a bank as trustee; the income was to be paid to the grantor's wife for life, with remainders over to their children; the grantor retained broad powers of management and control over the trust corpus and also retained the power to amend the trust provisions with respect to the distribution of the income or principal, except that he could not direct that the income should be paid to himself or that the corpus should revest in him. The court held that the income of the trust was taxable to the grantor, despite the fact that the trust was a long-term trust, because the grantor had retained broad management powers and the power to change the beneficial interests.

After the decision of the Supreme Court in the *Clifford* case, there was an enormous mass of litigation in the lower courts with respect to the taxation of trust income under the Clifford rule, and in 1946 the Treasury promulgated new Regulations (Sec. 29.22(a)–21) which set forth in great detail the types of trusts that will be considered by the Treasury as falling within the Clifford doctrine.** Those

* Commissioner v. Buck, 120 F.2d 775 (C.C.A. 2d 1941).

** These Regulations are applicable only with respect to taxable years beginning on or after January 1, 1946.

Sec. 29.22(a)-21

Regulations provide that the income of a trust is taxable to the grantor if the trust falls within *any* of the following three broad classes:

1) If the grantor retains a reversionary interest in the corpus or the income therefrom which will, or may reasonably be expected to, take effect within 10 years from the date of the transfer; or within 15 years from the date of the transfer if the grantor or his spouse (living with him and not having a substantial adverse interest) has any of several specified powers of management or control over the corpus.

2) If, irrespective of the term of the trust, the grantor or any person not having a substantial adverse interest has the power to alter the beneficial enjoyment of the income or the corpus. For example, if a grantor created a trust, income to his wife for life with remainders over to their children in equal shares, but retained the power to change the life beneficiary or to alter the distribution of the remainder interests, the income of the trust would be taxable to the grantor. The Regulations provide several important exceptions to this broad rule, that is, several types of powers that may be retained by the grantor or held by others without causing the income to be taxed to the grantor. These exceptions are set out fully in the Regulations and are not discussed here.

3) If, irrespective of the term of the trust, administrative control of either the corpus or the income of the trust is exercisable primarily for the benefit of the grantor rather than for the benefit of the beneficiaries. For example, if a grantor retained the right (whether or not as trustee) to borrow either the corpus or the income without adequate interest or without adequate security, that right would be considered as one exercisable primarily for the bene-

fit of the grantor and the income of the trust would be treated as taxable to him. The Regulations set out four different types of powers that are considered as powers exercisable primarily for the benefit of the grantor.

While the *Clifford* case taxed the grantor because of the short term of the trust, the close relationship of the grantor and beneficiary, *and* the management powers retained, under the Regulations the income of a trust may be taxed to the grantor because of (1) the short duration of the trust *or* (2) the power to change beneficial interests *or* (3) a power of administrative control that can be exercised primarily for the benefit of the grantor. The Regulations set out in great detail the circumstances that will or will not bring a trust within the above three broad subdivisions; and the Regulations as well as the case law need to be studied with great care. It is as yet too early to determine the extent to which those Regulations will be sustained by the courts.

The rules contained in Sec. 29.22(a)–21 of the Regulations relate only to the taxation of trust income to the *grantor*. The Clifford doctrine is however also applied to tax trust income to a third person in cases where a third person has the power to vest in himself either the income or the corpus of a trust. For example, if a trust instrument provided that the trustee was to accumulate the income during the life of X or pay the income over to X upon his request, the income would be taxed to X because of his power to obtain it, irrespective of whether a demand for the income was ever made. The provisions covering the taxation of trust income to third persons, under the Clifford rule, are contained in Sec. 29.22(a)–22 of the Regulations.

Single Trusts v. Multiple Trusts. There are two further points in connection with the taxation of trust income that should be mentioned. One is the question whether a trust

instrument which provides for the accumulation of income for the benefit of several beneficiaries creates a single trust for the benefit of all the beneficiaries or separate trusts, one for the benefit of each beneficiary. The importance of the question lies in the fact that if several trusts are created the trust income is divided into several piles and is therefore subject to tax at lower surtax rates. The answer depends, to a large extent, on the intention of the grantor as expressed in the trust instrument. If the instrument, for instance, provides that the corpus of the trust shall be divided and held in separate parts, that indicates an intention on the grantor's part to create separate trusts. And separate trusts may be created without a physical division of the corpus if it clearly appears that the grantor intended to create separate trusts and if the trust has been administered in accordance with that intention. The courts tend, however, to treat a single trust instrument as creating a single trust; this whole problem can be avoided if the grantor executes a separate trust instrument in favor of each beneficiary.

Trusts Taxable as Corporations. The other point that should be mentioned is the fact that under Sec. 3797 of the Code and the Regulations thereunder certain types of trusts are treated as associations taxable as corporations rather than as trusts. Sec. 3797(a)(3) provides that the term corporation includes "associations"; and the Regulations under Sec. 3797 contain rather detailed provisions with respect to the types of organizations classed as "associations", and the distinction between an "association" and an ordinary trust. The broad line of distinction is between a trust that merely holds and conserves property and collects the income, and a trust which carries on a business enterprise for profit; the first type of trust will be taxed as a trust while the second may be taxed as a corporation. The fact that a trust is a valid trust under local law does

not determine its status for tax purposes. It is the nature of the activities of the trust and the manner in which they are conducted that is determinative. If the trust is created to carry on a business activity and has the general characteristics of a corporation it will ordinarily be considered for tax purposes as an association taxable as a corporation.

Sec. 168 (Taxes of Foreign Countries and Possessions of United States) provides that the foreign tax credit shall be allowed to the beneficiaries of an estate or trust to the extent provided by Sec. 131; under the latter section the beneficiaries are allowed their proportionate shares of the foreign taxes as a credit. **Sec. 169 (Common Trust Funds)** is not discussed. **Sec. 170 (Net Operating Losses)** provides for the allowance of the net operating loss deduction to estates and trusts; certain special provisions with respect to the net operating loss deduction of estates and trusts are contained in the Regulations.

Sec. 171 (Income of an Estate or Trust in Case of Divorce, Etc.) which deals with certain alimony trusts should be read in conjunction with Sec. 22(k). Under Sec. 22(k) (discussed in Chapter 2), when alimony payments are made from a trust created pursuant to a decree of divorce or separation, or a written instrument incident thereto, the payments are taxed to the wife; that section does not, however, apply to payments from a trust created prior to the divorce or separation which payments are not pursuant to the decree or a written instrument incident thereto. Sec. 171 was therefore added to the Code by the 1942 Act to supplement the provisions of Sec. 22(k). Sec. 171 provides that the income of any trust which a wife, who is divorced or legally separated, is entitled to receive and which would otherwise be taxable to the husband (*i.e.*, income of a trust not covered by Sec. 22(k)) shall be taxed to the wife and shall not be taxed to the husband. Under

Sec. 171 as under Sec. 22(k), however, any payments that are specified by the decree or trust instrument as being for the support of minor children are taxed to the husband rather than to the wife. There is one rather important distinction between the two sections in that under Sec. 22(k) payments received by a wife from an alimony trust are included in her income irrespective of whether the payments are from income or from corpus; while under Sec. 171 the payments are included in the wife's income only to the extent they are made out of income.

Sec. 172 (Allowance of Amortization Deduction) is not discussed.

CHAPTER 9

SECTION 181 TO SECTION 265

Secs. 181–190—Partnerships.

Introduction. These sections which make up Supplement F of the Code contain the provisions covering the taxation of partnership income. A partnership is not subject to tax as a separate entity; but the partners include in their individual tax returns their distributive shares of the partnership net income or loss. The partnership itself does file a return, on Form 1065, but this is merely an information return. That return shows separately the computation of the partnership ordinary net income or loss and the partnership capital gains or losses; and then shows in a separate schedule each partner's distributive share of the ordinary net income or loss and the capital gains or losses.

Sec. 181 (Partnership Not Taxable) merely states that partners are liable for income tax only in their individual capacity.

Sec. 182 (Tax of Partners) provides that each partner shall include in his individual income tax return his distributive share of the partnership ordinary net income or loss and his distributive share of the partnership long-term and short-term capital gains or losses. These amounts are included in each partner's return irrespective of whether the partnership has actually distributed the amounts to the partners. Each partner reports his distributive share of the ordinary net income or loss of the partnership in Schedule E of Form 1040; his share of the ordinary net income is taxed at ordinary income tax rates or, if there is an ordinary net loss, his share of the loss offsets other income received in his individual capacity. He reports his share of the partnership's short-term and long-term capital gains or losses in exactly the same way as though they were his individual capital gains or losses. His proportionate share of any partially tax-exempt interest retains its exempt character in his individual re-

turn; and he is allowed to take as a credit against his individual tax his proportionate share of any foreign income taxes paid by the partnership which are allowable as a credit under Sec. 131.

Sec. 183 (Computation of Partnership Income) and Sec. 189 (Net Operating Losses) contain the rules for computing the partnership net income. The net income is computed in the same manner as the net income of an individual except for the following differences, which are set out in these sections.

1) Capital gains and losses, whether short-term or long-term, are segregated so that the partnership return shows separately the capital gains and losses and the ordinary net income or net loss (Sec. 183).

2) Charitable contributions made by the partnership are not allowed as a deduction in determining the partnership net income, but each partner is allowed to deduct in his individual return his proportionate share of such contributions (Sec. 183). The 15% limitation under Sec. 23(o) applies to the total charitable contributions of an individual whether made as an individual or through a partnership.

3) The standard deduction is not allowed (Sec. 183).

4) The net operating loss deduction is not allowed to the partnership; but an individual partner is allowed to include his share of a partnership net operating loss in computing his individual net operating loss deduction (Sec. 189). This computation is subject to very detailed rules set out in Sec. 29.189–1 of the Regulations.

Although not specifically mentioned in the Code, salaries that are paid to partners and any interest paid on the capital contributions of partners are not deductible as expenses in determining the net income of a partnership; those amounts

are deemed to represent a distribution of partnership profits.

Sec. 184 (Credits Against Net Income) provides that each partner shall be allowed in his individual income tax return, as a credit against net income, his proportionate share of the partially tax-exempt interest of the partnership. **Sec. 186 (Taxes of Foreign Countries and Possessions of United States)** provides that each partner shall be allowed in his individual income tax return, as a credit against the tax, his proportionate share of any foreign income taxes of the partnership that are allowable as a credit under Sec. 131. **Sec. 187 (Partnership Returns)** provides that all partnerships, irrespective of the amount of the gross or net income, shall file returns. As stated above, those returns are information returns and are filed on Form 1065.

Sec. 188 (Different Taxable Years of Partner and Partnership) states the rule for determining the year in which a partner shall report his distributive share of partnership income or loss when the taxable year of the partner is not the same as that of the partnership. The rule is the same as that provided by Sec. 164 with respect to trusts and estates. Each partner includes in his income for each taxable year his distributive share of the partnership net income or loss for the taxable year of the partnership which ends with or within the partner's taxable year. **Sec. 190 (Allowance of Amortization Deduction)** is not discussed.

There are several important questions with respect to partnerships that are not covered by the provisions of Supplement F. These are discussed briefly below.

Transfer of Assets to a Partnership. When upon the formation of a partnership, or at any later time, assets are transferred by a partner to a partnership, no gain or loss

is realized upon the transfer. Under the rule of Sec. 113 (a)(13) (discussed in Chapter 6), the basis of the assets in the hands of the partnership is the same as it was in the hands of the individual partner prior to the transfer.

Distribution of Assets by a Partnership. When a partnership distributes its assets *in kind* to the partners neither the partnership nor the individual partners realize gain or loss on the distribution. (On corporate distributions in kind, the corporation does not realize gain or loss but the distribution is ordinarily taxable to the stockholders.) This rule applies to any distribution by a partnership of assets in kind, whether the distribution is made upon the dissolution of the partnership or at any other time. Under Sec. 113(a)(13) (discussed in Chapter 6), the basis of the property in the hands of the partner is that part of the basis of the partner's "partnership interest" which is properly allocable to the property received. A partner's "partnership interest" is, in effect, the sum of his capital investment and his share of any undistributed income on which tax has been paid. The determination of the portion of the basis allocable to the property received is made by reference to the fair market value of the assets distributed as compared with the fair market value of all the assets of the partnership at the time of the distribution.

If, upon the dissolution of a partnership, a partner receives only cash for his interest, he realizes gain or loss at that time. If the liquidating distribution is partly in cash and partly in kind, the cash goes to reduce the basis of the partner's partnership interest and the reduced basis is then allocated among the assets received in kind.

Sale of a Partnership Interest. When a partner retires from a firm and sells his interest either to the remaining partners or to an incoming partner, gain or loss is realized in the amount of the difference between the proceeds of the

sale and the basis of the partner's partnership interest. A question that has caused considerable litigation in this connection is whether the gain or loss is an ordinary gain or loss or a capital gain or loss. It has been held by several Circuit Courts that a partner's interest in a partnership is a capital asset so that a sale of the interest results in a capital gain or loss. In some cases, however, as, for example, in a personal service partnership, the courts have held that amounts received by a retiring partner are not the proceeds of the *sale* of an interest but represent instead the retiring partner's share of earnings. Any excess of the amount received over the partner's partnership interest is therefore taxed as ordinary income. This question whether there is a *sale* of an interest also arises very frequently in connection with amounts paid by the surviving partners to the estate of a deceased partner.

Death of a Partner. When a partner dies, questions arise with respect to the taxation of the partnership income earned prior to the death of the partner and the partnership income earned thereafter. The executor of the deceased partner files an income tax return for the decedent from the beginning of the taxable year to the date of his death, and includes in that return the decedent's distributive share of the partnership income for that period.* The distributive share of the partnership income is determined according to the usual method of accounting followed by the part-

* If the partner and the partnership do not have the same accounting period, this return may include the deceased partner's distributive share of the partnership income for a period of more than twelve months. For example, assume that a partner reported on a calendar year basis and that the partnership reported on a fiscal year basis, the fiscal year ending on June 30; and that the partner died on November 30, 1947. The last return of the decedent would include his distributive share of the partnership income both for the fiscal year ending on June 30, 1947 and for the period July 1 to November 30, 1947.

nership. The decedent may, therefore, be entitled to certain amounts of partnership income earned prior to his death which are not included in his last return. For example, if a partnership reported on a cash basis, income earned but not received by the partnership at the time of the decedent's death would not be included in the partnership income for the period ending with the decedent's death; if a partnership reported on an accrual basis, income attributable to work in progress which was not completed at the time of the decedent's death would not be included in the partnership income for that period. Under the provisions of Sec. 126, the decedent's distributive share of these amounts of income earned by the partnership prior to the decedent's death is included in gross income, when received, by the estate or beneficiary who receives the payments. The right to those payments of income is also an asset of the estate and is included in the estate tax return of the decedent; and the estate or person who includes the payments in gross income is allowed a deduction of the estate tax attributable to the payments, under the provisions of Sec. 126(c).

More difficult questions arise when, under the terms of a partnership agreement, the surviving partners pay to the estate of a deceased partner certain amounts in addition to the deceased partner's capital investment in the partnership and his share of income earned prior to death. The main question is whether the payments represent amounts paid by the surviving partners *in purchase* of the deceased partner's interest or represent the estate's share of the income of a continuing partnership of which the estate is, in effect, a partner. The treatment of these payments concerns not only the income tax liability of the deceased partner's estate but also the income tax liability of the surviving partners. No general rules can be laid down as to when these payments will be treated as purchase payments and when as income payments. The determination depends largely on the terms of the partnership agreement and the

nature of the partnership. The problems involved are too complex for any full discussion here and the case law should be carefully read.* Once it is determined whether the payments are purchase payments or income payments, the tax consequences are as follows.

If the payments are treated as made in purchase of the deceased partner's partnership interest, the value of the right to the payments is included in the gross estate of the deceased partner for estate tax purposes. The payments when received are not income to the estate (except to the extent by which they may exceed the amount at which the payments were valued in the estate tax return). The entire partnership income is taxed to the surviving partners; the payments made to the estate of the deceased partner are not deductible by the surviving partners but are treated as additional capital contributions.

If, on the other hand, the payments are treated as representing the estate's share of the income of a continuing partnership, the tax results are as follows. The value of the right to the payments is included in the gross estate of the deceased partner for estate tax purposes. The estate of the deceased partner is subject to income tax on the payments when received but is allowed a deduction under Sec. 126(c) for the estate tax attributable to the inclusion in the gross estate of the value of the right to the payments. The surviving partners are taxed only on their own distributive shares of the partnership income and not on the full amount of the partnership income.

Other Organizations Treated as Partnerships; and Partnerships Taxed as Corporations. Under the provisions of

* For a discussion of the tax effects of different provisions in partnership agreements, see Bull v. United States, 295 U.S. 247 (1935); Charles F. Coates, 7 T.C. 125 (1946); Raymond S. Wilkins, 7 T.C. 519 (1946), aff'd, 161 F.2d 830 (C.C.A. 1st 1947).

Sec. 3797 of the Code and the Regulations thereunder, certain organizations that are not technically partnerships are treated as partnerships; on the other hand, certain partnerships recognized as such by local law may be taxed as corporations rather than as partnerships.

Sec. 3797(a)(2) of the Code provides that the term partnership includes "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not * * * a trust or estate or a corporation". A joint venture, for example, which is not technically a partnership must file a partnership return and the income of the joint venture is taxed to the members thereof as though they were partners.

Sec. 3797(a)(3) of the Code includes "associations" within the term corporation so that if an organization is an "association" it is taxable as a corporation even though it may be a partnership under local law. The Regulations provide that an organization is an association taxable as a corporation if (1) the organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and (2) its management is centralized in one or more persons in their representative capacities. The fact that the members may be subject to the personal liability of partners will not prevent such an association from being taxed as a corporation. The Regulations contain a fairly detailed discussion of the types of organizations that are deemed to be included within the term "association" and there is considerable case law with respect to organizations that are or are not associations taxable as corporations.

A limited partnership that is formed under the laws of a state that has adopted the Uniform Limited Partnership Act may be treated either as a partnership or as an association taxable as a corporation, depending on the existence of the particular characteristics noted above. When a

limited partnership is formed under the laws of a state which has not adopted the Uniform Act, the local law should be examined carefully, since under the laws of some states limited partnerships are granted characteristics which may automatically bring them within the term "association" under the tax law. The Bureau has issued several rulings with respect to the tax status of limited partnerships formed under the laws of particular states.

Family Partnerships. The most highly litigated question in the field of partnership tax law has recently been the tax status of family partnerships. This question was discussed briefly in Chapter 2 at page 35. As stated there, the Supreme Court held, in the *Tower* and *Lusthaus* cases,* that a husband-wife partnership would not be recognized for tax purposes when the wife had contributed no capital originating with her, had not contributed to the control or management of the business, and had not rendered any other substantial services to the business. The income-splitting provisions of the 1948 Revenue Act removed much of the incentive for forming husband-wife partnerships but the questions involved are still important with respect to partnerships including a child or family trust. The decisions in the *Tower* and *Lusthaus* cases do not, of course, mean that all family partnerships will be refused recognition for tax purposes. Both the Tax Court and the Circuit Courts have held in a number of cases, decided after the Supreme Court's decisions, that a family partnership (including a wife or child or family trust) has tax validity because, under the particular facts of the case, the new partner had contributed additional capital or had rendered services, or both. Each case has to be determined on its own facts and no general rules can be laid down at the present time as to the

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* Commissioner v. Tower, 327 U.S. 280 (1946); Lusthaus v. Commissioner, 327 U.S. 293 (1946).

amount of capital or of services that must be contributed by the new partner before the partnership will be recognized for tax purposes.

Secs. 201–207 (Supplement G—Insurance Companies) are not discussed.

Secs. 211–219—Nonresident Alien Individuals.

Introduction. These sections which make up Supplement H of the Code contain the provisions with respect to the taxation of nonresident alien individuals. Of those sections, Sec. 211 is the most important.

The tax treatment of nonresident aliens must be distinguished from the tax treatment of resident aliens. Resident aliens are taxed on their entire taxable income, irrespective of its source; and are subject to all the general provisions of the Code which apply to both citizens and residents. Nonresident aliens are taxed *only* on income from United States sources;* the provisions of Supplement H apply only to this group of aliens. The provisions of the 1948 Revenue Act permitting income-splitting by husband and wife do not apply if either the husband or wife was a nonresident alien at any time during the taxable year; such spouses cannot file a joint return (see Sec. 51, discussed in Chapter 4).

The rules for determining whether an alien is a resident alien or a nonresident alien are set out in Secs. 29.211-2—29.211-5 of the Regulations. An alien is deemed to be a resident of the United States (1) if he comes here to live for an indefinite period, that is, if he has no definite intention as to the length of his stay here, or (2) if he comes here for a

* The source of income is determined under the provisions of Sec. 119, discussed in Chapter 7.

definite purpose that will, by its nature, require an extended stay and therefore temporarily makes his home here, even though he intends to return to his own country at the end of the period. On the other hand, an alien is deemed to be a nonresident of this country if he comes here for a definite purpose which is of such a nature that an extended stay will not be necessary. Under ordinary circumstances, an alien who is in this country on a temporary or a visitor's visa is deemed to be a nonresident alien. It should also be remembered that the class of nonresident aliens includes individuals who are not physically present in the United States at all but who may nevertheless be subject to United States income tax because of the fact that they receive income from United States sources.

If an individual is properly classified as a nonresident alien, his tax liability is determined under the provisions of Supplement H. It should be emphasized again that the gross income of a nonresident alien is *only* the gross income from United States sources; in the balance of this section dealing with nonresident aliens, the term gross income is used to mean only gross income from United States sources.

Sec. 211 (Tax on Nonresident Alien Individuals) contains three subsections dealing with the method of taxing nonresident aliens, but there are actually only two main classes of nonresident aliens. Secs. 211(a) and 211(c) deal with the same class—that is, nonresident aliens who are *not* engaged in trade or business in this country; the only difference between the Sec. 211(a) and the Sec. 211(c) nonresident aliens is that the Sec. 211(c) nonresident aliens have a larger amount of gross income. Sec. 211(b) deals with nonresident aliens who are engaged in trade or business in the United States.

A nonresident alien who performs personal services in this country for which he receives compensation is considered as being engaged in trade or business here (with one

minor exception with respect to certain nonresident aliens present in this country for only short periods). Also, a nonresident alien is considered as being engaged in trade or business in this country if he is a member of a partnership that is engaged in trade or business here, even though the individual himself is not directly engaged in trade or business in this country (Sec. 219). However, the act of selling securities or commodities on a domestic exchange or through a resident broker does not constitute doing business here if the nonresident alien has no office here from which the transactions are directed.

Sec. 211(a) deals with nonresident aliens not doing business here whose gross income is not more than $15,400. These nonresident aliens are taxed at a flat rate of 30% on their *gross* income; they are allowed no deductions, credits or exemptions. Under the statute, however, the gross income of these Sec. 211(a) nonresident aliens includes only items of "fixed or determinable annual or periodical" income.* The one important income item on which these nonresident aliens are not taxed is capital gains, since such gains are not annual or periodical income. There is a practical reason for exempting nonresident aliens who are not engaged in trade or business in this country from tax on capital gains. If they were taxed on capital gains, many of them would simply sell their securities and other capital assets outside the country. Since nonresident aliens are subject to tax *only* on income from United States sources a large portion of the gains would still escape United States income tax. The main result might be only that those security (and other) sales would be driven out of the domestic exchanges and markets and into foreign markets.

Sec. 211(c) deals with nonresident aliens not doing

* There is one exception applicable to both the Sec. 211(a) and the Sec. 211(c) nonresident aliens in that gross income does not include interest on deposits with persons carrying on the banking business; this exception is referred to in the discussion of Sec. 119, in Chapter 7.

business here whose gross income is more than $15,400. The *gross* income of these nonresident aliens is determined in the same way as that of the Sec. 211(a) nonresident aliens and includes only items of "fixed or determinable annual or periodical" income; in particular, capital gains are not included in the gross income and are not subject to tax. The income subject to tax and the tax are, however, computed differently. In the computation of net income, these nonresident aliens *are allowed* certain deductions. The deductions (other than the deduction for charitable contributions) are allowed, however, *only* to the extent that they are allocable to items of gross income required to be included in the return. These nonresident aliens are also allowed one personal exemption (under Sec. 214). The tax of these nonresident aliens is computed according to the normal and surtax rates applicable to citizens and residents, with the one proviso that the total tax shall not be less than 30% of the gross income (Sec. 211(c)(3)). This proviso is necessary in order that the tax on the Sec. 211(c) nonresident aliens shall in no case be less than the tax on the Sec. 211(a) nonresidents. The breaking point between the Sec. 211(a) and the Sec. 211(c) nonresident aliens was fixed at $15,400 by the Revenue Act of 1942 because of the fact that under the normal tax and surtax rates of that Act the effective rate of tax on the income of a citizen or resident would, in the ordinary case, have begun to exceed 30% at approximately the $15,400 gross income level; and it was not intended that nonresident aliens should be subject to a lower rate of tax than citizens and residents. Under present tax rates the actual breaking point is closer to $20,000.

Sec. 211(b) deals with nonresident aliens who are engaged in trade or business in this country. The *gross* income of these nonresident aliens is determined in the same way as the gross income of citizens or residents, with the one exception that the gross income includes only income

from United States sources; the gross income of these nonresident aliens *does* include capital gains. The net income of these nonresident aliens is determined under the provisions of Sec. 213, discussed below; these nonresident aliens are also allowed one personal exemption under Sec. 214; and the tax is computed according to the usual rates applicable to citizens and residents.

Sec. 212 (Gross Income) provides, in its first subsection, the rule stated above that the gross income of a nonresident alien includes only gross income from United States sources. Sec. 212(b) provides that the earnings of a nonresident alien derived from the operation of ships or aircraft documented or registered under the laws of a foreign country are exempt from tax, *if* the laws of the foreign country grant an equivalent exemption to United States citizens and corporations.

Sec. 213 (Deductions) sets out the rules with respect to deductions allowed to nonresident aliens. This section is easier to understand if it is read in connection with the Regulations (Sec. 29.213-1) since the Regulations state the deduction rules separately for each of the three classes of nonresident aliens. No deductions are allowed to the Sec. 211(a) nonresident aliens since they are taxed on their *gross* income from United States sources. The Sec. 211(c) nonresident aliens are allowed, with one exception, only such deductions as are allocable to the gross income required to be included in the return. The exception is that they are allowed the deduction for charitable contributions as provided by Sec. 213(c), whether or not connected with income from United States sources.

The Sec. 211(b) nonresident aliens are allowed deductions to the extent that they are connected with income from United States sources (Sec. 213(a)); the deduction for charitable contributions, whether or not connected with in-

come from United States sources, as provided by Sec. 213(c); and also certain losses under Sec. 213(b). Sec. 213(b)(1) allows a deduction for the losses under Sec. 23(e)(2) (losses not connected with a trade or business but incurred in a transaction entered into for profit), whether or not the losses are connected with income from United States sources, but only if the profit if there had been a profit would have been subject to tax. Sec. 213(b)(2) allows a deduction for the losses under Sec. 23(e)(3), whether or not the casualty losses are connected with income from United States sources, but only if the loss is of property within the United States.

The standard deduction provided in Sec. 23(aa) is not allowed to any nonresident aliens.

Sec. 214 (Credits Against Net Income) provides that a nonresident alien shall be allowed only one personal exemption—that is, no exemptions or credits are allowed for a spouse or dependents.* This provision applies only to the Sec. 211(b) and the Sec. 211(c) nonresident aliens; no exemption at all is allowed to the Sec. 211(a) nonresident aliens since they are taxed on *gross* income. **Sec. 215 (Allowance of Deductions and Credits)** provides that deductions and credits shall be allowed to a nonresident alien only if he files a true and accurate return in accordance with the provisions of Sec. 217. If a nonresident alien does not file a return and a tax is later assessed by the Commissioner, the tax is imposed on the entire gross income. **Sec. 216 (Credits Against Tax)** provides that a nonresident alien shall not be allowed the foreign tax credit provided by Sec. 131.

Sec. 217 (Returns) and Sec. 218 (Payment of Tax) contain the requirements for the filing of returns and the pay-

* The Regulations contain special provisions with respect to the personal exemption and credits allowed to residents of Canada and Mexico.

ment of the tax. Nonresident aliens who are subject to tax under Sec. 211(a) do not need to file returns at all *if* the tax on their gross income has been fully withheld at the source. As provided in Sec. 143(b) (discussed in Chapter 8), tax is required to be withheld on income payable to all nonresident aliens and the withholding rate is 30%. Nonresident aliens who *are* required to file returns (except those who have tax withheld on their wages under the current tax payment system *) file their returns and pay the total amount of the tax due on the 15th day of the *sixth* month following the close of the calendar or fiscal year. For calendar year taxpayers, the filing date is therefore June 15 rather than March 15. Also, nonresident aliens do not have the privilege of paying the tax in installments. **Sec. 219 (Partnerships)** contains the rule referred to above that a nonresident alien is deemed to be engaged in trade or business in this country if he is a member of a partnership that is engaged in trade or business here.

One additional point that should be kept in mind is that under the income tax treaties which the United States has entered into with several foreign countries there are special provisions which affect the United States tax liability of both resident and nonresident aliens, as well as of United States citizens. The Regulations under Secs. 211–219 point out many of these provisions of the treaties; but the treaties themselves and the Regulations thereunder should be examined in the case of any individual who may come within their terms. At the present time, the United States has treaties affecting income tax liabilities with the United Kingdom, Canada, France, Sweden and the Union of South Africa.

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* These nonresident aliens file returns and pay tax at the same time as citizens and residents.

Secs. 231–237—Foreign Corporations.

Introduction. These sections which make up Supplement I of the Code contain the provisions with respect to the taxation of foreign corporations. As in the case of nonresident alien individuals, foreign corporations (whether resident or nonresident) are taxed only on income from United States sources. Foreign corporations are divided into two classes: (1) corporations not engaged in trade or business in this country, called nonresident foreign corporations, and (2) corporations that are engaged in trade or business in this country, called resident foreign corporations. The term "engaged in trade or business in this country" has the same meaning in the case of foreign corporations as in the case of nonresident alien individuals. The performance of personal services in this country does constitute doing business here, while the act of selling securities or commodities through a resident broker or on a domestic exchange does not constitute doing business here.

Sec. 231 (Tax on Foreign Corporations) provides, in its first subsection, that a nonresident foreign corporation shall be taxed at a flat rate of 30% on its gross income; the gross income includes, however, only items of fixed or determinable annual or periodical income * and does *not* include capital gains. These provisions are the same as those of Sec. 211(a) with respect to the taxation of the Sec. 211(a) nonresident alien individuals. Since the tax is levied on *gross* income, nonresident foreign corporations are allowed no deductions or credits.

Sec. 231(b) provides that resident foreign corporations shall be taxed as provided in Sec. 14(c)(1) and Sec. 15.

* As in the case of the Sec. 211(a) and the Sec. 211(c) nonresident alien individuals, the gross income of nonresident foreign corporations does not include interest on deposits with persons carrying on the banking business.

The total tax rate provided by those sections is not quite the same as the tax rate on domestic corporations. All resident foreign corporations pay *normal* tax at a flat rate of 24%; they are not allowed the benefit of the lower normal tax rates allowed to domestic corporations with net income of less than $50,000. The surtax on foreign corporations is, however, levied at the same rates applicable to domestic corporations so that foreign corporations with net income of less than $50,000 do obtain the benefit of the lower surtax rates provided by Sec. 15.

Sec. 231(c) contains the rule stated above that the gross income of foreign corporations includes only gross income from United States sources. Sec. 231(d), which is comparable to Sec. 212(b), exempts foreign corporations from tax on earnings derived from the operation of ships or aircraft documented or registered under the laws of a foreign country, if the laws of the foreign country grant an equivalent exemption to United States citizens and corporations.

Sec. 232 (Deductions), Sec. 233 (Allowance of Deductions and Credits) and Sec. 234 (Credits Against Tax) contain the rules with respect to the deductions and credits of *resident* foreign corporations. Under Sec. 232, these corporations are allowed deductions only to the extent that they are connected with income from United States sources, with the one exception that the deduction for charitable contributions is allowed whether or not connected with income from United States sources. Under Sec. 233, foreign corporations are allowed the benefit of deductions and credits only if they file true and accurate returns; if a return is not filed and the Commissioner later assesses a tax, the tax is imposed on the gross income. This provision, like that of Sec. 215 with respect to nonresident alien individuals, is designed as a penalty on any attempt to avoid the tax by failing to file a return. Under Sec. 234, foreign

corporations are not allowed the foreign tax credit provided by Sec. 131.

Sec. 235 (Returns) and Sec. 236 (Payment of Tax) contain the requirements for the filing of returns and the payment of the tax. Resident foreign corporations file returns and pay the tax at the same time and in the same manner as domestic corporations. Nonresident foreign corporations file returns and pay the total tax on or before the 15th day of the *sixth* month (rather than of the third month) following the close of the taxable year. Also, as in the case of nonresident alien individuals subject to tax under Sec. 211(a), nonresident foreign corporations whose United States tax is fully withheld at the source do not need to file returns. **Sec. 237 (Foreign Insurance Companies)** is merely a cross reference section relating to foreign insurance companies.

As in the case of alien individuals, there are special provisions in the income tax treaties between the United States and several foreign countries which affect the tax liability of corporations organized in this country and in those foreign countries; and those provisions need to be examined in determining the tax liability of any corporation to which they may be relevant.

Secs. 251–252 (Supplement J—Possessions of the United States) and Secs. 261–265 (Supplement K—China Trade Act Corporations) are not discussed.

CHAPTER 10

PROCEDURAL PROVISIONS

SECTION 271 TO SECTION 322

Introduction. The sections covered in this chapter contain the basic procedural provisions of the Code. These provisions are divided among four Supplements: Supplement L (Secs. 271–277) relating to deficiencies, Supplement M (Secs. 291–299) relating to interest and additions to the tax, Supplement N (Secs. 311–313) relating to claims against transferees and fiduciaries, and Supplement O (Secs. 321–322) relating to overpayments. The provisions of Supplement N, relating to claims against transferees and fiduciaries, are not discussed. The provisions of Supplements L, M, and O are not discussed in detail but are merely outlined in brief form. Each Supplement is discussed separately as a unit; and only the more important sections within each supplement are referred to (not necessarily in their statutory order).

The main steps that follow the filing of a return, when there is either a deficiency in tax or an overpayment, are first outlined in order to provide a setting in which the statutory provisions may be more easily understood.

After an income tax return has been filed it is audited by a revenue agent employed in the office of the Internal

Revenue Agent in Charge of the district in which the return was filed.* The return will ordinarily be audited about two or three years after it is filed. The agent may determine that the tax as shown on the return is correct; or he may determine that there is either a deficiency in or an overpayment of the tax.

If the revenue agent decides that there is a deficiency in the tax as shown on the return, the first step is an informal conference between the revenue agent and the taxpayer or his auditor or accountant or attorney. If no agreement is reached on the correct amount of the tax, the revenue agent's office for that district sends to the taxpayer what is called a "30-day letter". This is a preliminary notice of the deficiency as determined by the revenue agent and has attached to it a report showing the computation of the deficiency. There is no provision for the 30-day letter in the Code or the Regulations; it is merely a part of the administrative procedure that has been developed for the settlement of disputed tax liabilities. At this point, the taxpayer has 30 days (which is often extended) in which to file a "protest" with the revenue agent's office in which he sets forth his reasons for not agreeing to the deficiency.

After the protest is filed, there is another conference, or conferences, in the revenue agent's office with a Conferee who is also an employee of the Bureau attached to that particular revenue agent's office. If an agreement is not reached between the Conferee and the taxpayer, the taxpayer can request that the case be transferrd to the Technical Staff. There are ten Technical Staff offices each of

* Returns of individuals with adjusted gross income of less than $7,000 are not audited by revenue agents; those returns are sampled and a small percentage of them are audited in the Collector's offices. A large percentage, although not all, of corporate returns and of returns of individuals with adjusted gross income of $7,000 or more are audited, the percentage increasing with the size of the income shown on the return.

which has jurisdiction over a geographical area that includes the districts of several revenue agent's offices. After the case is transferred to the Technical Staff, a further conference is arranged between the taxpayer and the Staff member to whom the case is assigned.

If the case is settled and the amount of the deficiency agreed to, either while the case is in the revenue agent's office or in the office of the Technical Staff, a Form 870 which states the amount of the deficiency agreed upon is signed by the taxpayer and the Commissioner.*

If no agreement is reached either with the revenue agent's office or with the Technical Staff, a statutory notice of deficiency is issued by the revenue agent's office in the name of the Commissioner. This statutory notice is provided for by Sec. 272(a) of the Code and is ordinarily called a 90-day letter since the taxpayer has 90 days in which to file a petition with the Tax Court for a redetermination of the deficiency. The Commissioner cannot actually *assess* a deficiency (unless the taxpayer executes a waiver on Form 870, under Sec. 272(d), discussed below) until 90 days after this statutory notice has been mailed to the taxpayer or, if the taxpayer files a petition with the Tax Court, until the decision of the court has become final (Sec. 272(a)).**

There are two paths a taxpayer can take with respect to a deficiency, and he must make his choice *before* he files

* When the settlement is made in the revenue agent's office (but not when it is made in the Technical Staff office) the settlement is subject to review in Washington by the Audit Review Division and is sometimes upset although in the usual case the decision of the revenue agent's office is accepted.

** Under Sec. 273 the Commissioner has the power to make an assessment without prior notice in cases where he believes collection of the tax will be jeopardized by delay. The Commissioner must, however, mail the statutory notice to the taxpayer within 60 days of the assessment. The taxpayer then has the usual 90 days after the mailing of the notice in which to petition the Tax Court but the tax may actually be collected in the meantime unless a bond is filed.

a petition with the Tax Court. One method of procedure is to file a petition with the Tax Court for a redetermination of the deficiency; under this procedure the taxpayer can litigate his case before he pays the deficiency. The other method of procedure is to pay the deficiency and then file a claim for its refund (on Form 843); and, if the claim for refund is not allowed, to sue for the refund in the proper federal district court or in the Court of Claims. It is important to notice that if the refund method is followed the litigation is always in either the district court or the Court of Claims; this is because the Tax Court does not have jurisdiction over suits for refund. If the taxpayer wishes to use the refund method of procedure, he can pay the asserted deficiency at any time after it is first asserted by the revenue agent and before he has filed a petition with the Tax Court. A disadvantage of the refund method of procedure is that the taxpayer has to part with the money representing the additional tax prior to a court determination of the correct amount of the deficiency; * an advantage of the refund method of procedure is that by the payment of the asserted deficiency the taxpayer stops the running of interest and also gains additional time in which to commence his action.**

If the refund claim method is followed the taxpayer has the same opportunities for conferences with the revenue agent's office and the Technical Staff as when a protest against a deficiency is filed; in this case the conferences are concerned with the question whether the refund should be

* In cases where the return includes other disputable items (in addition to the one with respect to which the claim is made) this disadvantage may be serious since it is standard Bureau policy to examine the entire return for possible offsetting items before making any refund.

** If the taxpayer files a petition with the Tax Court, he can, if he wishes, pay the asserted deficiency at any time after the mailing of the notice of deficiency. This stops the running of interest on the deficiency and the Tax Court still retains jurisdiction of the case.

made. If the refund is not allowed, or if no settlement is reached, a statutory notice of the disallowance of the refund claim is issued in the name of the Commissioner (Sec. 3772). The taxpayer can commence his action for refund at any time within two years after the statutory notice of disallowance is issued; or, if the statutory notice of disallowance is not issued within six months after the claim for refund is filed, he can commence his action at the end of the six-month period even though the statutory notice has not been issued.

Supplement L (Secs. 271–277)—Assessment and Collection of Deficiencies.

This supplement contains the provisions relating to the assessment and collection of deficiencies. As stated before, under the provisions of Sec. 272(a) the Commissioner cannot ordinarily assess a deficiency, and no court action can be commenced for the collection of a deficiency, until after the statutory notice of deficiency (the 90-day letter) has been issued. (There is one exception to this rule if a waiver under Sec. 272(d), discussed below, is filed.) This rule makes it necessary for the Commissioner to issue the 90-day letter before the expiration of the statutory period of limitation upon assessment and collection. The different periods of limitation are set out in Sec. 275 and Sec. 276. The three most common periods within which a tax must be assessed are the following:

1) The general period of limitation is three years from the date the return was filed (Sec. 275(a)).*
2) If the taxpayer failed to report in his return amounts in excess of 25% of the gross income as shown on the return, the period of limitation is five

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* If a return is filed prior to the due date, the period runs from the due date and not from the date of filing (Sec. 275(f)).

years instead of three years (Sec. 275(c)).

3) If the taxpayer filed no return at all or filed a fraudulent return, there is no period of limitation and a deficiency can be assessed or a court proceeding begun for the collection of the tax at any time (Sec. 276(a)).

Other periods of limitation applicable to particular situations are set out in Secs. 275 and 276. When the period of time during which the Commissioner can assess a deficiency for a particular year has expired, and no statutory notice of deficiency has been issued, that year is ordinarily called a "closed year".

After the 90-day letter is issued, the taxpayer has 90 days from the date of mailing * in which to file a petition with the Tax Court for a redetermination of the deficiency (Sec. 272(a)(1)). The Commissioner cannot (unless a waiver under Sec. 272(d) is executed) assess a deficiency until (1) if the taxpayer does not file a petition with the Tax Court, the 90-day period has expired, or (2) if the taxpayer does file a petition with the Tax Court, the decision of the court has become final (Sec. 272(a)). The statutory period of limitation is suspended, after the mailing of the 90-day letter, for the period during which the Commissioner is prohibited from making an assessment and for 60 days thereafter (Sec. 277).

Under the provisions of Sec. 272(d), the taxpayer may, if he decides to pay the asserted deficiency or if a settlement is reached with respect to the amount of the deficiency, execute a waiver of the restrictions against assessment and collection by signing a Form 870. If this waiver is filed, the Commissioner can assess the deficiency without issu-

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* This period cannot be extended; if a petition is going to be filed, it must be filed within that time. Conferences looking toward settlement can, however, be continued with the Technical Staff both during and after the 90-day period up to the time of trial.

ing a statutory notice of deficiency and waiting for the statutory period to expire; the taxpayer thereby saves interest charges.

On the other hand, the taxpayer may be requested to sign a different kind of waiver, on Form 872 (Sec. 276(b)), extending the time during which the Commissioner can issue the 90-day letter and assess a deficiency. Taxpayers ordinarily execute these forms on request since if the time is not extended the Commissioner will automatically issue a 90-day letter in the full amount of the deficiency asserted. The execution of the waiver provides more time for the settlement of the case and also extends the time during which the taxpayer can file a claim for refund (Sec. 322 (b)(3), discussed below).

Supplement M (Secs. 291–299)—Interest and Additions to the Tax.

This supplement contains the provisions with respect to (1) interest and (2) additions to the tax which are, in effect, civil penalties.

The main provisions with respect to interest are contained in Sec. 292 and Sec. 294. If the tax shown on the return, or any installment of the tax, is not paid on the due date, interest runs at 6% from the due date until the date of payment (Sec. 294(a)). If a deficiency is determined, interest on the deficiency runs at 6% from the date the tax as shown on the return was due * until the date the deficiency is assessed or, if a waiver (on Form 870) is filed under Sec. 272(d), until the thirtieth day after the filing of the waiver (Sec. 292(a)).** If a deficiency or interest

* If the tax was paid in installments, this date is the date prescribed for the payment of the first installment.

** Interest at 6% is also paid by the Government on any overpayment of tax, but only from the date or dates the tax was paid and not from the date the tax was due.

thereon or penalties are not paid when due (ten days from the date of notice and demand from the Collector) interest runs at 6% from the date of the notice and demand until the date of payment (Sec. 294(b)).

The provisions with respect to civil penalties, called in the Code "additions to the tax", are contained in Sec. 291, Sec. 293 and Sec. 294. The most important of these civil penalties are:

1) If a taxpayer fails to file a return on or before its due date without reasonable cause, the penalty is 5% of the tax for each thirty days (or fraction thereof) during which the failure continues, but not exceeding a total of 25% (Sec. 291(a)).

2) If a deficiency is due to negligence, or intentional disregard of the statute or Regulations but without fraud, the penalty is 5% of the deficiency (Sec. 293 (a)).

3) If a deficiency is due to fraud with intent to evade tax, the penalty is 50% of the deficiency (Sec. 293 (b)).

4) If a taxpayer substantially underestimates his estimated tax so that his estimate is less than 80% of the actual tax, the penalty is either (a) 6% of the difference between the estimated and actual tax or (b) the difference between the estimated tax and 80% of the actual tax, whichever is the lesser (Sec. 294(d)).

Supplement N (Secs. 311–313)—Claims Against Transferees and Fiduciaries. The provisions of this supplement relate to the liability of transferees and fiduciaries when assets have been transferred without adequate provision having been made for the payment of tax liabilities. The provisions of this supplement are not discussed.

Supplement O (Secs. 321–322)—Overpayments.

This supplement contains the provisions with respect to the crediting or refunding of overpayments of tax. There may be an overpayment because the tax shown on the return was or proved to be excessive. Or an overpayment may result from the payment of a deficiency. As pointed out above, the taxpayer may have paid an asserted deficiency (rather than petitioning the Tax Court) intending at the time to use the refund claim method for its recovery. In either case, the taxpayer's first step is to file a claim for refund on Form 843.

If the refund claim is allowed, the amount of the refund is first credited against any income taxes that are due from the taxpayer and any balance is refunded to him (Sec. 322(a)). If the refund claim is disallowed, a statutory notice of the disallowance is issued to the taxpayer in the name of the Commissioner (Sec. 3772). The taxpayer cannot begin his suit on the refund claim until either (1) six months have elapsed from the date the refund claim was filed or (2) the Commissioner has issued a statutory notice of disallowance, whichever time is earlier; and the suit must be begun within two years from the date of the mailing of the statutory notice of disallowance. A taxpayer cannot, in any case, bring suit for a refund unless he has first filed a claim for refund within the statutory period. (The provisions with respect to *suits* for refund are contained in Sec. 3772 of the Code.)

Sec. 322(b)(1) provides the general rule as to the period of limitation within which a refund claim must be filed. The claim must be filed within three years from the date the return was filed * or within two years from the date the tax was paid, whichever date is later. Unless such a claim is filed no refund or credit of the overpayment can be

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* If the return was filed prior to the due date, the period runs from the due date rather than from the date of filing (Sec. 322(b)(4)).

made after the period of limitation has expired. Sometimes a refund or credit is allowed without the filing of a claim but that can only be done *before* the expiration of the statutory period. It should be noted that the period during which a claim for refund can be filed may often extend to a date long subsequent to the filing of the return, since if a deficiency is paid a claim for refund to the extent of the deficiency can be filed within a two-year period from the date of payment of the deficiency.*

It was pointed out above, in the discussion of deficiency assessments, that, under the provisions of Sec. 276(b), the taxpayer and the Commissioner may execute a waiver on Form 872 which *extends* the time during which a deficiency can be assessed. This waiver also extends the time during which the taxpayer can file a refund claim. The taxpayer can file a refund claim at any time during the extended period and six months thereafter (Sec. 322(b)(3)).

Secs. 322(b)(2) and 322(b)(3) state the limits on the *amount* of refund or credit. The general rules are:

1) If the claim is filed within three years from the time the return was filed, the amount of refund or credit cannot exceed the tax paid during the three-year period just preceding the filing of the claim.
2) If the claim was not filed within three years from the time the return was filed, the amount of refund or credit cannot exceed the tax paid during the two-year period just preceding the filing of the claim.
3) If a waiver under Sec. 276(b) is executed (extending the time for the assessment of a deficiency and the filing of a refund claim) within three years from the time the return was filed, the amount of

* This means, of course, a deficiency that has been paid by a taxpayer who has *not* filed a petition with the Tax Court. If a deficiency is paid in accordance with a decision of the Tax Court, the taxpayer cannot thereafter file a refund claim to recover the amount (Sec. 322(c)).

refund or credit cannot exceed the total of (a) the tax paid during the three-year period just preceding the execution of the waiver and (b) any tax paid after the execution of the waiver but paid during the extended period and six months thereafter.

Sec. 322(b)(5) provides a special period of limitation for claims for refund or credit based on deductions for bad debts under Secs. 23(k)(1) and 23(k)(4) and for losses from worthless securities under Secs. 23(g)(2) and 23 (k)(2). In those cases a claim for refund can be filed within seven years (rather than three years) from the date the return was filed. Also, the amount of refund or credit that can be claimed on account of the deductibility of these items is not limited to the taxes paid during the periods set out above. This special provision, which was referred to in Chapter 3, was added to the Code because of the fact that it is in many cases extremely difficult for taxpayers to determine the correct year in which to take a deduction for a bad debt or for a loss on securities that become worthless.

Sec. 322(c) provides the general rule referred to earlier that, if a taxpayer has filed a petition with the Tax Court with respect to a deficiency asserted for a particular year, he cannot thereafter obtain a refund or credit of the tax for that year and cannot bring suit for the recovery of the tax in any court. The main exception * to this rule is that the taxpayer can recover the amount of any overpayment that is determined by a decision of the Tax Court which has become final (Sec. 322 (c)(1)). Although the Tax Court does not have jurisdiction over suits for refund, it does have power, in connection with a proceeding before it for the redetermination of a deficiency, to find that as to the particular tax and the particular year involved there was an overpayment of tax rather than a deficiency (Sec. 322(d)).

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* There are two minor exceptions to this rule in Secs. 322(c)(2) and 322(c)(3) which are not of general importance.

As pointed out before, the taxpayer has to choose one out of two alternative methods of procedure with respect to an asserted deficiency—either (1) to petition the Tax Court for a redetermination of the deficiency or (2) to pay the deficiency, file a claim for refund, and litigate, if necessary, in the District Court or the Court of Claims. Under the provisions of Sec. 322(c) the taxpayer cannot first litigate the case in the Tax Court and then, if he loses in that court and has to pay the deficiency, continue the litigation in a District Court or the Court of Claims by bringing suit for a refund of the deficiency that he has paid. There is nothing in the Code, however, that prevents a taxpayer from litigating an issue as to *one* year in the Tax Court and litigating the same issue for a *different* year in a District Court or in the Court of Claims.

CHAPTER 11

PERSONAL HOLDING COMPANIES

SECTION 331 TO SECTION 340 AND SECTION 500 TO SECTION 511

Introduction.

The last sections in Chapter 1 of the Code that are discussed are Secs. 331–340 which make up Supplement P and deal with *foreign* personal holding companies. There is, however, a somewhat more important group of sections contained in Chapter 2 of the Code—Secs. 500–511 which make up Subchapter A of Chapter 2 and deal with personal holding companies generally. The provisions of both Supplement P and Subchapter A are discussed in this chapter. Both Supplement P and Subchapter A were added to the

Code by the 1937 Revenue Act to close certain tax avoidance loopholes.*

Before the enactment of Subchapter A the following practices, among others, could be and were successfully carried out. A wealthy individual would organize a wholly-owned corporation and transfer income-producing property to it. After the transfer, the corporation would collect the income from the property and pay tax at a much lower rate than would have been payable if the income had been received by the individual. The corporation would not pay dividends but would accumulate the balance of the income after tax. The corporation could later be liquidated and the individual would pay only a low capital gain tax on the liquidation; or, if the individual held the stock until his death, the stock would pass to his estate or legatees with a new high basis (fair market value as of the time of acquisition, under Sec. 113(a)(5)) and the income would never become subject to the individual income tax. Before 1934 the Commissioner's only weapon against this practice was Sec. 102, which proved inadequate. Beginning in 1934, personal holding companies were removed from the coverage of Sec. 102 and subjected to a special, more stringent, surtax. However, until 1937, there were so many loopholes in the personal holding company surtax provisions that this method of tax avoidance was still possible. This particular type of corporation has often been called an incorporated pocketbook.

Another practice that developed and was sometimes successful was the incorporation of yachts and residential estates. A taxpayer would, for example, transfer to a wholly-owned corporation his country estate together with

* Special provisions with respect to personal holding companies were first enacted by the 1934 Act, but those provisions had been too weak to prevent tax avoidance through the use of the personal holding company. Supplement P and Subchapter A were first enacted in approximately their present form by the 1937 Act.

income-producing securities; he would then pay rent to the corporation for the use of the estate. (The rent would be paid in order to remove the corporation from the personal holding company classification as it existed prior to the 1937 Act.) The corporation would include the rent and the income from the securities in its gross income but would offset the entire income by expenses incurred in operating the estate (which would be deducted as business expenses); the result would be that the income from the securities would not be subject to any income tax but would instead be offset by otherwise nondeductible, personal expenses.

One other practice that was sometimes successful was the incorporation of personal talents. An individual, such as a high-salaried motion picture star, would form a corporation and contract to render his services to it for, say, $20,000 a year; the corporation would then contract out the services to a third person for, say, $200,000 a year; the balance of $180,000 would be held and accumulated by the corporation subject to only the low corporate tax.*

The foreign personal holding company, before the enactment of Supplement P, was operated somewhat differently. It must be remembered that under Sec. 231(c) a foreign corporation is subject to United States tax *only* on income from United States sources. A simple tax avoidance method was, therefore, for an individual to organize a foreign corporation (in a country having either no income tax or a low rate of tax), transfer funds to it, and invest those funds in foreign securities, or in such a way that the income from them would arise outside the United States. The foreign corporation would be subject to no United States tax since none of its income would be from United States sources.

* This type of corporation was not a personal holding company under the law prior to the 1937 Act. Sec. 102, the penalty surtax on corporations improperly accumulating surplus, which was in the law at that time, applied, therefore, to this type of corporation but that section had not proved to be a very efficient weapon in forcing corporations to distribute their earnings.

The corporation could therefore freely accumulate income for its owner and, so long as no dividends were paid, no United States tax would be payable by either the corporation or the individual.

Tax avoidance methods of those types were effectively curbed by the 1937 Act which enacted Supplement P and Subchapter A in approximately their present form. Since both Supplement P and Subchapter A deal with personal holding companies and since Subchapter A is of more general interest, the provisions of that subchapter are discussed first.

Subchapter A (Secs. 500–511)—Personal Holding Companies.

The provisions of Subchapter A apply to domestic corporations that come within the definition of a personal holding company set out in Sec. 501; and also to foreign corporations that come within that definition, if the foreign corporation does not come within the definition of a "foreign personal holding company" set out in Sec. 331 (in Supplement P). The method adopted to prevent tax avoidance through the use of personal holding companies that come within the provisions of Subchapter A is to impose a surtax, *in addition to* the ordinary corporate normal tax and surtax, on the *undistributed* income of such companies at so high a rate that it is a tax disadvantage for the corporation to retain the income. At the present time, the rates of the personal holding company surtax are 75% on the first $2,000 and 85% on the balance of the undistributed income. Because these surtax rates are so high, it is extremely important that the corporations which are subject to the surtax should be very clearly defined; otherwise, legitimate business corporations would be penalized. It is for this reason that Secs. 501, 502 and 503 are so long and detailed.

Throughout Subchapter A the term "Subchapter A net

income'' is used. This term exists merely for convenience of reference and means the net income of the corporation as it is determined for personal holding company purposes. The Subchapter A net income is the net income of the corporation, as computed for the corporate normal tax and surtax, after certain adjustments under Sec. 505 have been made. The personal holding company surtax is imposed only on the undistributed portion of the Subchapter A net income.

Personal holding companies are required to file a special return on Form 1120H in addition to the regular corporate return on Form 1120.

Sec. 500 (Surtax on Personal Holding Companies) sets out the rates of the personal holding company surtax, which are 75% on the first $2,000 of the undistributed Subchapter A net income and 85% on the balance. This surtax is, as stated before, *in addition to* the ordinary corporate normal tax and surtax.

Sec. 501 (Definition of Personal Holding Company) defines, in its first subsection, the corporations that are subject to the personal holding company surtax. It should be noted that the section applies to *any* corporation that meets its requirements, not merely to domestic corporations. It is possible, therefore, for a foreign corporation to come within the provisions of this section and to be subject to the personal holding company surtax under Subchapter A.

There are two separate requirements that must be met before a corporation is classified as a personal holding company—the gross income requirement and the stock ownership requirement; unless *both* those requirements are met a corporation is not a personal holding company. The gross income requirement is that at least 80%* of the

* This percentage is 70% instead of 80% in certain cases set out in Sec. 501(a) if the corporation was a personal holding company in a prior year.

gross income of the corporation for the taxable year must be income from certain specified sources—called "personal holding company income" and defined in Sec. 502. In determining the proportions of personal holding company income and other income the amounts to be compared are the amounts of gross income and not gross receipts. The stock ownership requirement is that more than 50% (in value, not in number of shares) of the outstanding stock must be owned, directly or indirectly, by not more than five individuals at some time during the last half of the taxable year.

Sec. 501(b) lists certain types of corporations that are *not* personal holding companies under Subchapter A. Among these are *foreign* personal holding companies as defined in Sec. 331 which corporations are taxed under the provisions of Supplement P. In some cases, a foreign corporation will not come within the definition of Sec. 331 in Supplement P but will be a personal holding company within the provisions of Subchapter A. A foreign corporation is not a foreign personal holding company under Supplement P unless more than 50% of its stock is owned (at any time during the taxable year) by not more than five individuals who are citizens or residents of the United States. If, therefore, more than 50% of a foreign corporation's stock is owned by four citizens of the United States and one nonresident alien, the four citizens owning not more than 50%, the corporation will not be a foreign personal holding company under Supplement P but may be a personal holding company under Subchapter A if the gross income requirement of that Subchapter is met.

Sec. 502 (Personal Holding Company Income) lists the kinds of income that are "personal holding company income". Unless 80% or more of a corporation's gross income in a taxable year consists of income of these kinds, the corporation is not a personal holding company. The prin-

cipal types of personal holding company income, as listed in the subsections of Sec. 502, are:

a) Dividends, interest, royalties and annuities (with certain exceptions).

b) Gains on the sale or exchange of stock or securities, unless the taxpayer is a dealer in stock or securities.

c) Gains from futures transactions in commodities (with certain exceptions).

d) Income from estates or trusts; and gains from a sale or other disposition of an interest in an estate or trust.

e) Amounts received under a contract under which the corporation is to furnish personal services, if some person other than the corporation has the right to designate the individual who is to perform the services, or if the individual is designated in the contract; *and if* the individual who is to perform the services owned, at some time during the taxable year, 25% or more in value of the corporation's stock. This provision is designed to prevent the practice of incorporating personal talents, referred to above.

f) Amounts received as compensation for the use of the corporation's property, if at any time during the taxable year the individual entitled to the use of the property owned 25% or more in value of the corporation's stock. This provision is designed to prevent the practice of incorporating yachts and country estates, referred to above.

g) Rents, unless the rents constitute 50% or more of the corporation's gross income. The exception is designed to protect ordinary real estate corporations from being classed as personal holding companies.

h) Mineral, oil or gas royalties, with an exception designed to protect legitimate operating companies from being classed as personal holding companies.

Secs. 500–511

Sec. 503 (Stock Ownership) sets out in its first subsection the rules to be applied in determining whether more than 50% of a corporation's stock is owned *directly or indirectly* by not more than five individuals. These rules are not discussed in detail. Under the three rules set out in the first three subdivisions, an individual is considered as owning, not only the stock he owns directly, but also:

1) His proportionate share of stock owned, directly or indirectly, by a corporation of which he is a stockholder, or a partnership of which he is a partner, or an estate or trust of which he is a beneficiary.
2) Stock owned, directly or indirectly, by his family or his partner; the term "family" includes a spouse, ancestors, descendants, and brothers and sisters.
3) Stock which he has an option to acquire.

The other three subdivisions of Sec. 503(a) provide rules for the application of the foregoing rules in particular situations. Sec. 503(b) provides that securities which are convertible into stock shall be considered as stock, according to the rules set out in that section.

Sec. 505 (Subchapter A Net Income) provides the rules for determining the Subchapter A net income and is discussed in advance of Sec. 504 which provides the rules for determining the *undistributed* Subchapter A net income.

Under Sec. 505, the Subchapter A net income is the net income of the corporation after certain adjustments are made. Sec. 505(a) provides for the allowance of certain additional deductions, the most important of which are federal income taxes (but not the Sec. 102 penalty tax or the personal holding company surtax), and charitable contributions in excess of the 5% deduction allowed by Sec. 23(q) (subject to certain limitations). Secs. 505(b) and 505(c) then provide that certain deductions are *not* allowed. Expenses and depreciation allocable to property owned by the

corporation which are in excess of the income from the property are not deductible unless the corporation meets the burden of proof imposed on it and shows, in general, that the property was actually used as it would have been used by an ordinary business corporation. The net operating loss deduction under Secs. 23(s) and 122—the two-year carry-over and two-year carry-back of losses—is not allowed. Personal holding companies are, however, allowed the one-year carry-over of the net operating loss of the preceding year, under Sec. 26(c); that loss is allowed as part of the dividends paid credit.

Sec. 504 (Undistributed Subchapter A Net Income) lists the amounts that are to be deducted from the Subchapter A net income in determining the undistributed Subchapter A net income. The most important deduction is the dividends paid credit under Sec. 27(a) which is allowed by Sec. 504(a), subject to certain limitations. It was explained in Chapter 4 in connection with the discussion of Sec. 27 that the dividends paid credit for the purpose of the personal holding company surtax is the sum of: the dividends paid during the year, the consent dividends credit, the one-year net operating loss credit under Sec. 26(c), and the dividend carry-over. The discussion of Sec. 27 in Chapter 4 should be referred to for an explanation of these items.

One additional point should be noted in connection with the dividends paid during the year which are a part of the dividends paid credit. The term "dividend" as it is ordinarily used in the Code, and as defined in the first sentence of Sec. 115(a), means a distribution out of earnings and profits. The term "dividend" has, however, a broader meaning when it is used in connection with distributions by a personal holding company. The last sentence of Sec. 115(a) provides that *any* distribution by a personal holding company to its stockholders, to the extent of its Sub-

chapter A net income after certain adjustments,* is a dividend; in other words, it does not matter whether or not the distribution is out of earnings or profits. This special provision is included in the Code because of the fact that a personal holding company might have Subchapter A net income in a particular year but no earnings or profits. The company might, for example, have net capital losses which decrease earnings or profits but do not reduce net income. Under this special definition of a dividend, any distribution to stockholders (to the extent of the Subchapter A net income, as adjusted) is a dividend and can be deducted in determining the undistributed Subchapter A net income subject to the personal holding company surtax.

Certain additional amounts are deductible under the provisions of Secs. 504(b) and 504(c). Sec. 504(b) allows the deduction of reasonable amounts used to pay or retire indebtedness incurred prior to January 1, 1934, which was the date the first personal holding company surtax under the 1934 Act became effective.

Sec. 504(c) allows the deduction of additional amounts which are paid as dividends prior to the 15th day of the third month following the close of the taxable year. Because of the high rate of the surtax, a personal holding company always attempts to pay out sufficient dividends to avoid the imposition of the surtax. It sometimes happens, however, that the company's estimate of its income just prior to the close of the taxable year is incorrect so that the dividends paid during the year are not sufficient to avoid the personal holding company surtax. In that case, the company can pay a further dividend during the first two and one-half

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* More precisely, a distribution is a dividend to the extent of the company's Subchapter A net income *less* the sum of (1) the net operating loss credit under Sec. 26(c), (2) the dividend carry-over, and (3) the deduction allowed by Sec. 504(b) for amounts for retirement of certain indebtedness.

months of the following year and have that amount allowed as a deduction in determining its undistributed Subchapter A net income for the taxable year; this further amount is, however, allowed as a deduction only to the extent that it does not exceed 10% of the sum of the dividends actually paid during the taxable year and the consent dividends credit for that year. If this 10% is still not sufficient to avoid the imposition of the personal holding company surtax, the company can still avoid the surtax by using consent dividends.

Sec. 506 (Deficiency Dividends—Credits and Refunds) relates to "deficiency dividends". Since these provisions are extremely technical and since any occasion for their use is infrequent, the provisions are not discussed in any detail. The general purpose and effect of the provisions are as follows. After a personal holding company return for a particular year has been audited, it may develop that all of the Subchapter A net income, after the adjustments under Sec. 504, was not distributed and a deficiency in personal holding company surtax may be determined.* At the time the deficiency is determined, it is too late for the corporation to pay additional dividends or to use consent dividends as a means of avoiding the imposition of the personal holding company surtax. Sec. 506 therefore provides that, after the amount of the deficiency is finally determined in accordance with the particular rules of that section, the corporation can pay additional dividends in the later year in an amount sufficient to wipe out the deficiency for the earlier year and thus avoid the imposition of the personal holding company surtax. When a corporation distributes deficiency divi-

* In some cases a deficiency may result from the fact that the company's directors did not know that the company was, in that particular year, a personal holding company; a company can, for example, fall within the personal holding company classification for just one year because of a slight shift either in the stock ownership or in the nature of the gross income.

dends, the dividends are reported by the stockholders as income in the later year of distribution and tax is paid by the stockholders at the rates applicable to that year.

Sec. 507 (Meaning of Terms Used), Sec. 508 (Administrative Provisions), Sec. 509 (Improper Accumulation of Surplus), Sec. 510 (Foreign Personal Holding Companies), and Sec. 511 (Publicity of Returns) are definition and cross-reference sections which need no discussion.

Supplement P (Secs. 331–340)—Foreign Personal Holding Companies.

The provisions of Supplement P apply only to foreign corporations that come within the definition set out in Sec. 331. As pointed out above, if a foreign personal holding company comes within that definition it is excluded from the coverage of Subchapter A dealing with personal holding companies in general. The provisions of Supplement P are discussed only briefly since most of the provisions are either the same or very similar to the comparable provisions of Subchapter A. The important distinction between the provisions of Supplement P and those of Subchapter A is in the method of taxing the undistributed income of Supplement P corporations.

Sec. 331 (Definition of Foreign Personal Holding Company) provides that a foreign corporation is a foreign personal holding company only if it meets both the gross income requirement and the stock ownership requirement set out in that section. The gross income requirement is similar to that in Subchapter A except that the percentage of personal holding company income required is 60%* rather

* As in the case of Subchapter A corporations, this percentage is reduced (to 50%) in certain cases set out in Sec. 331 if the corporation was a foreign personal holding company in a prior year.

than 80%. The stock ownership requirement is that more than 50% (in value) of the outstanding stock must be owned at *any* time during the taxable year by not more than five individuals who are United States citizens or residents, called a "United States group".

Sec. 332 (Foreign Personal Holding Company Income) and Sec. 333 (Stock Ownership) list, respectively, the kinds of income that are foreign personal holding company income and the rules to be applied in determining the ownership of the stock of the corporation. These rules are almost identical with those of the comparable sections of Subchapter A. **Sec. 334 (Gross Income of Foreign Personal Holding Companies)** provides that the gross income of the corporation shall be computed as if the corporation were a domestic corporation—that is, amounts are included in income irrespective of whether they are from United States or from foreign sources.

Sec. 335 (Undistributed Supplement P Net Income) provides the rules for determining the undistributed Supplement P net income; and **Sec. 336 (Supplement P Net Income)** provides the rules for determining the Supplement P net income. The rules of Sec. 336 for determining the Supplement P net income are very similar to the rules of Sec. 505 for determining the Subchapter A net income; there are certain additional amounts that are not allowed as deductions, under Sec. 336(b). Under Sec. 335, the undistributed Supplement P net income is determined by deducting from the Supplement P net income the basic surtax credit as provided by Sec. 27(b) (discussed in Chapter 4), with a minor adjustment with respect to the credit for partially tax-exempt interest. It should be noted that this computation is different from the computation of the undistributed Subchapter A net income since the basic surtax credit allowed as a deduction to Supplement P corporations does not in-

clude the dividend carry-over that is allowed to Subchapter A corporations. The reason for this difference lies in the different method of taxing the undistributed income of Supplement P corporations.

Sec. 337 (Corporation Income Taxed to United States Shareholders) sets out the method of taxing the undistributed income of foreign personal holding companies. The section does not impose any additional tax on the corporation itself; but, very generally, each stockholder who is a United States citizen or resident (including domestic corporations, partnerships, and estates and trusts) is required to include in his gross income, as a dividend, his proportionate share of the undistributed Supplement P net income of the corporation. In other words, insofar as citizens and residents of the United States are concerned, the corporate entity is ignored and the undistributed income is taxed directly to the shareholders irrespective of whether it has been distributed.

One further disadvantage inherent in a foreign personal holding company is that when stock or securities of such a company are acquired by bequest, devise, or inheritance or by the decedent's estate, they can never acquire a higher basis under Sec. 113(a)(5); they have as their basis the same basis they had in the hands of the decedent or the fair market value at the time of acquisition, whichever is lower.

Sec. 338 (Information Returns by Officers and Directors), Sec. 339 (Information Returns by Shareholders), and Sec. 340 (Penalties) are not discussed.

CHAPTER 12

CONCLUSION

The sections of Chapter 1 of the Code following Supplement P are not discussed. Those sections deal with special groups of taxpayers or with highly specialized situations, as shown by the following summary:

Supplement Q (Secs. 361–362)—Regulated Investment Companies

Supplement R (Secs. 371–373)—Exchanges and Distributions in Obedience to Orders of Securities and Exchange Commission

Supplement S (Secs. 391–396)—Tax of Shareholders of Personal Service Corporations

Supplement T (Secs. 400–404)—Individuals with Adjusted Gross Income of Less than $5,000

Supplement U (Sec. 421)—Abatement of Tax for Members of Armed Forces upon Death

Chapter 2 of the Code now contains Subchapter A relating to personal holding companies, which has been discussed in Chapter 11, and Subchapter D providing the tax on Unjust Enrichment, which is not discussed. In previous years Chapter 2 of the Code contained the provisions of the now-repealed excess profits tax. That tax is not now of immediate interest to the student although it will undoubtedly be a long time in litigation.

The balance of the Internal Revenue Code, that is, Chapter 3 to Chapter 48, is concerned primarily with estate and gift taxes, various excise taxes, admission and due taxes, liquor and cigarette taxes, together with a host of manufacturers' excise taxes. Those taxes are not covered in this book.

There are, however, certain provisions contained in

Chapter 37 of the Code—Abatements, Credits and Refunds, and in Chapter 38--Miscellaneous Provisions, of which the reader should be aware since these provisions affect income tax liabilities.

Chapter 37—Abatements, Credits and Refunds, contains the provisions with respect to interest on overpayments and interest on judgments. That chapter also contains, in Sec. 3772, the provisions with respect to suits for refund.

Chapter 38—Miscellaneous Provisions, contains two particularly important sections. Sec. 3797 gives the definitions of many terms that are used throughout the Code such as "partnership" and "corporation"; that section has been referred to at various points in the text of the book. Sec. 3801 is a very important although very complicated section. It is designed, in general, to prevent the government from taxing the same income in two different years and to prevent the taxpayer from escaping liability for the tax in both years. The section applies only in certain specific and rigidly defined situations. In cases where the section does apply, it operates to permit the assessment of a deficiency or the refund of an overpayment for a prior year for which an assessment or refund would otherwise be barred by the statute of limitations.

The Introduction to this book can also serve as its conclusion. The book is not a treatise on income tax law. An attempt at complete coverage would have obscured the basic principles in a mass of detail and of information of a very limited and specialized interest.

The book is planned as a guide for those who wish to understand income tax law. The place to begin is with the general structure of the Code and the meaning of its basic provisions. Therefore, this book has been confined to an explanation of the fundamental provisions of the Internal Revenue Code, the more important Regulations and those court decisions which have become a part of the basic structure of the tax law. As stated in the Introduction, the

book is intended to give the reader a general familiarity with tax law, to point out the problems rather than to give all the answers, and particularly to provide a foundation on which a wider knowledge can be built.

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THE FEDERAL INCOME TAX

A GUIDE TO THE LAW

BY

STANLEY and KILCULLEN

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Page 28. Sec. 29.22(a)-13—Cancellation of Indebtedness

In the *Jacobson* case* the Supreme Court was faced with the problem of reconciling its decisions in the *Kirby* and *American Dental* cases, a problem which had been bothering the lower courts ever since the latter case was decided. In the *Jacobson* case, a solvent individual debtor bought in some of his own bonds at less than par. He acquired some directly from the individual bondholders and some from the secretary of a bondholder's committee and from security houses. The Tax Court had held that the *American Dental* rule applied to the first group, where there were direct negotiations between the debtor and creditor, but that the *Kirby* rule applied to the second group. The Seventh Circuit Court held that the *American Dental* rule applied to all the purchases since all the sellers knew the bonds were being purchased by or for the maker. The Supreme Court reversed and held that the *Kirby* rule applied to all the purchases and that the amount of the debt cancelled was income. The Court held that in this case the creditors intended to transfer their entire claim

* Commissioner *v.* Jacobson, 336 U. S. 28 (1949).

for the best possible price. It distinguished this type of transaction from what it says was the *American Dental* type of transaction in which there is a transfer of "a part of a claim for cash and the balance for nothing". The Court went on to say "the latter situation is more likely to arise in connection with a release of an open account for rent or for interest"—the exact transaction involved in the *American Dental* case. This decision so limits the application of the *American Dental* rule as to virtually destroy its practical importance and, in fact, Mr. Justice Rutledge in his concurring opinion stated that he believed the two opinions were essentially in conflict.

Pages 28 and 40. Sec. 22(b)(9) (Income From Discharge of Indebtedness)

The life of this section, which was first enacted as a temporary provision, has again been extended. As amended, the section is not to apply to any discharge of indebtedness occurring in taxable years beginning after December 31, 1950.

Page 35. Sec. 22(a)—Assignment of Income

The Supreme Court in its decision in the *Culbertson* case* has expanded on the family partnership rules previously set out in the *Tower* and *Lusthaus* cases in order to correct what it considered misinterpretations of those decisions by the lower courts. The case involved a partnership of a father and four sons. The Tax Court had held that none of the sons were partners for tax purposes and had been reversed by the Fifth Circuit Court. The Supreme Court remanded the case to the Tax Court for further proceedings in conformity with its opinion. According to the Court's opinion

* Commissioner *v.* Culbertson, U. S. (1949).

the two questions whether the new partner contributes capital originating with him and whether he contributes services are not, as the lower courts seemed to feel, the ultimate questions for decision. It held that the ultimate question is whether considering all the facts the parties "in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise". The capital and service tests are merely two factors, although important ones, to be considered in deciding that ultimate question. The opinion also makes two important statements with respect to the capital and service tests themselves. On the question of capital, the Court makes clear that "original capital" can be property received from another partner so long as the new partner exercises control over the property and through that control is able to influence the conduct of the partnership. As to the service test, the Court seems to say that services must be rendered during the taxable year. This would mean that a partner whose status as such rests primarily or entirely on services would be a partner in only those years in which services were actually rendered. Although the statement of the Court appears to be without qualification it is doubtful that it will establish a general rule, particularly in view of the statement in Mr. Justice Burton's concurring opinion that physical absence during the taxable year does not necessarily preclude partnership status.

Page 35, second footnote. Sec. 22(a)—Assignment of Income

The decision of the Tax Court in the *Farkas* case was reversed by the Fifth Circuit.* That court held that a transfer by the taxpayer of all his interest in a testamentary trust to a trust created by him, which was to terminate at the end of ten years or upon the death of the

* Farkas *v.* Commissioner, 170 F. 2d 201 (C. C. A. 5th 1948).

trustee, was a substantial transfer of property and not merely an assignment of future income. A concurring opinion pointed out that the ten year period in this case was the same as the dividing line established by the Treasury Regulations in classifying Clifford trusts.

In *Hawaiian Trust Co., Ltd.* v. *Kanne,** the Ninth Circuit held that the transfers under consideration were substantial transfers of corpus and that the assignor was not taxable on the income. In that case a life beneficiary of a trust irrevocably assigned portions of the trust income for periods measured by her son's liability under a divorce decree. The decree required the son to make payments to his wife for life or until her remarriage and to make further payments for the support of his minor children (then 9 and 10 years old) until their majority. The court pointed out that under the Clifford regulations trusts created for periods as long as these would have been effective to shift the tax liability on the income.

Page 157. Sec. 112(g) (Business Purpose)

See discussion of preferred stock received in a recapitalization or as a dividend at page 8 below.

Page 161. Sec. 112(b)(5) (Transfer to Corporation Controlled by Transferor)

In *Mather & Co.* v. *Commissioner,*** the Third Circuit rejected the relative value test applied in the *United Carbon* and *Bodell* cases and held that the "control test" should be applied in determining whether the stock and securities received by each transferor were substantially in proportion

* 172 F. 2d 74 (C. C. A. 9th 1949).
** 171 F. 2d 864 (C. C. A. 3rd 1949).

to his interest in the property transferred. In the *United Carbon* and *Bodell* cases the "control test" had been considered and rejected by the Fourth and First Circuit Courts. Under the control test, each taxpayer's percentage of the total assets transferred is compared with his percentage of the total stock and securities received. In the example in the text, for instance, transferor A transferred a 25% interest in the assets and received a 30% interest in the securities, an increase of 5%, whereas transferor C transferred a 55% interest in the assets and received a 45% interest in the securities, a decrease of 10%. In this example, the spread under the control test is only 15% while it is 38% under the relative value test. The result of the application of the control test in the *Mather* case was to treat the exchange as nontaxable. The court stated that the same result could have been reached in this particular case by applying the relative value test and treating the liabilities assumed by the transferors as "stock or securities", but held that the relative value test was not the correct one. The court's specific rejection of the relative value test may mean that the question will eventually have to be decided by the Supreme Court.

Page 166. Sec. 112(b)(6) (Property Received by Corporation on Complete Liquidation of Another)

The Tax Court and the Third Circuit have now agreed with the position taken by the Sixth Circuit in the *Tri-Lakes Steamship* case—that a distribution consisting only of cash comes within the provisions of Sec. 112(b)(6). In *International Investment Corporation,** which was affirmed by the Third Circuit, the Tax Court expressly stated that it would no longer follow an earlier decision of the Board to the contrary.

* 11 T. C. 678 (1948), aff'd F. 2d (C. C. A. 3rd 1949).

Page 166. Sec. 112(b)(6) (Property Received by Corporation on Complete Liquidation of Another)

The question referred to in the text, whether property is distributed in liquidation of a subsidiary under Sec. 112 (b)(6) when the parent corporation is both a creditor and a stockholder of the subsidiary and the subsidiary is solvent at the time of liquidation, has been passed on by the Fifth Circuit in *Houston Natural Gas Corporation* (*Texas*) v. *Commissioner.** In that case the parent had acquired at a discount all the bonds of its several subsidiaries and later liquidated the subsidiaries. It was admitted that the liquidation was tax free under Sec. 112(b)(6) but the Commissioner argued successfully that the assets distributed in liquidation were only those assets in excess of the face value of the bonds. Contrary to the opinion expressed in the text that the debt due the parent would presumably be considered to have been extinguished on liquidation, the court here considered it to have been paid in full. This decision may raise difficult questions with respect to the basis of the assets acquired by the parent since the assets received in payment of the bonds should have a basis of fair market value while those received in liquidation retain the same basis they had in the hands of the subsidiary.

Page 205. Sec. 115—Stock Dividends

Although the Supreme Court's decision in the *Strassburger* case has not yet been directly challenged, the Bureau has indicated that in at least some circumstances a dividend paid in preferred on common stock, no preferred being previously outstanding, may be taxable. In a special ruling, dated December 29, 1947,** the Bureau considered a proposed plan under which a corporation would increase its

* 173 F. 2d 461 (C. C. A. 5th 1949).

** 5 CCH 1948 Fed. Tax Rep. ¶ 6059; 5 P-H 1948 Fed. Tax Serv. ¶ 76, 191.

common stock outstanding and then pay a dividend in preferred stock on the common. There was no preferred previously outstanding. The request for a ruling had given assurances that there were no existing arangements for the sale of any of the preferred stock and no intention on the part of the stockholders to sell, or on the part of the corporation to redeem, the preferred stock. The Bureau ruled that under these circumstances the preferred stock dividend would be nontaxable. However, the Bureau expressly stated that the ruling gave no opinion with respect to the tax consequences of a subsequent sale or redemption of the preferred stock. By this ruling the Bureau indicated that in cases where preferred stock received as a dividend is sold or redeemed in accordance with a preconceived plan either the stock dividend or the proceeds of sale or redemption may be taxed as an ordinary dividend. In cases where there are no prior arrangements for the sale or redemption of the preferred (by sinking fund or otherwise) the preferred stock dividend itself will be nontaxable, but the Bureau has left open the question of the tax effect of a later sale or redemption of the preferred.

This ruling followed the Supreme Court's decision in the *Adams* and *Bazely* cases and would apply to preferred stock received in recapitalizations as well as to preferred stock received as a dividend.

Page 208. Sec. 115—Effect of Distributions on Earnings and Profits

The statement in the text that the *Sansome* rule has been extended to apply to the transfer of deficits in a tax-free reorganization or liquidation, so that a deficit in earnings and profits of a transferor is carried over and reduces the earnings and profits of a transferee, referred to the decision of the Tenth Circuit in the *Phipps* case. That deci-

sion has now been reversed by the Supreme Court.* In that case a parent corporation with accumulated earnings and profits liquidated five subsidiaries in Sec. 112(b)(6) liquidations; one of the subsidiaries had earnings and four had aggregate deficits in excess of the parent's earnings. The Court held that the deficits of the four subsidiaries could not be carried over to wipe out the earnings of the parent. The Court stated that the *Sansome* rule requiring the carry-over of earnings was developed in order to prevent tax avoidance. The rule cannot be applied to permit the carry-over of a deficit since that would allow a subsidiary's deficit to reduce or wipe out the earnings and profits of a parent which, absent the liquidation or reorganization, would have been taxable as dividends on distribution.

Page 288. Sec. 211 (Tax on Nonresident Alien Individuals)

It is explained in the text that neither the Sec. 211(a) nor the Sec. 211(c) nonresident aliens, *i. e.*, those who are not doing business in this country, are taxed on their capital gains. That there can be a serious question whether a particular transaction is a sale of a capital asset or a commutation of ordinary income is illustrated by the decision of the Supreme Court in the *Wodehouse* case.** In that case the taxpayer purported to sell the exclusive serial rights in several of his books for lump sum payments. The Court held that the amounts received by the taxpayer were not the proceeds of sales but were royalties. The Court also held that royalties, even though paid in a lump sum, are taxable to a nonresident alien. In the Court's opinion, the phrase in Sec. 211 referring to "fixed or determinable annual or periodical" income does not mean that money must be paid annually or periodically rather than in a

* Commissioner *v.* Phipps, 336 U. S. 410 (1949).

** Commissioner *v.* Wodehouse, 337 U. S. 369 (1949).

lump sum to be subject to tax, but merely describes the kinds of income on which withholding of tax is practicable. Those kinds of income are taxable to nonresident aliens even though received in a lump sum.

Page 292. Nonresident Aliens—Treaties

At the present time the United States has income tax treaties in effect with the United Kingdom, Canada, France, Sweden, Denmark and the Netherlands. It is stated in the text that the treaty with the Union of South Africa is in effect; actually, that treaty is still awaiting the exchange of ratifications. Treaties have also been signed, and are now awaiting the exchange of ratifications, with Belgium, Norway and New Zealand. Supplementary treaties with France have also been signed and are awaiting the exchange of ratifications.

Page 297. Procedural Provisions

On June 18, 1948 the Commissioner of Internal Revenue created two additional Technical Staffs so that there are now twelve rather than ten as stated in the text.